S. Hrg. 103–759

ABANDONMENT OF THE PRIVATE RIGHT OF ACTION FOR AIDING AND ABETTING SECURITIES FRAUD/STAFF REPORT ON PRIVATE SECURITIES LITIGATION

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

ON

THE RECENT SECURITIES LAW DECISIONS BY THE U.S. SUPREME COURT, CENTRAL BANK OF DENVER VS. FIRST INTERSTATE BANK OF DENVER. IN A 5–4 DECISION, THE COURT WIPED OUT PRIVATE LIABILITY FOR THOSE WHO "AID AND ABET" SECURITIES FRAUD

STAFF REPORT ON PRIVATE SECURITIES LITIGATION

MAY 12, 1994

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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ABANDONMENT OF THE PRIVATE RIGHT OF ACTION FOR AIDING AND ABETTING SECURITIES FRAUD/STAFF REPORT ON PRIVATE SECURITIES LITIGATION

THURSDAY, MAY 12, 1994

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The Subcommittee met in room 538, of the Dirksen Senate Office Building at 2:40 p.m., Senator Christopher J. Dodd (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. The Committee will come to order.

Welcome everyone here to our hearing this afternoon. We are here to examine one of the more significant recent Securities law decisions by the U.S. Supreme Court, Central Bank of Denver vs. First Interstate Bank of Denver. In that rather sweeping 5 to 4 decision, the Court wiped out private liability for those who, "aid and abet securities fraud." While aider and abettor liability may sound like a dry and arcane point of law to many, it is not.

As our witnesses will tell us this afternoon, aiding and abetting is the common law legal doctrine that provides liability for those who do not directly violate the law but who provide assistance to the unlawful acts of others.

In my view, aiding and abetting liability has been critically important in deterring individuals from assisting possible fraudulent acts by others. Until the Supreme Court changed the landscape a few weeks ago, aiding and abetting liability was an important tool in ensuring honesty and high professional standards by individual professionals who facilitate access to the securities markets.

Over several decades, courts in virtually every circuit in the United States have applied aiding and abetting liability in cases under the Federal Securities laws. In addition, the Securities and Exchange Commission has long used aiding and abetting liability as part of its arsenal of legal remedies.

I think the essence of the Supreme Court's decision was captured in one sentence of that opinion, and let me quote it:

> To be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances. The issue however is not whether imposing private liability on aiders and abettors is good policy but whether aiding and abetting liability is covered by the statute.

That one quotation succinctly explains, in my view, why we're here today. Five Justices looked at the language of the statute and decided to set aside policy consequences and, frankly, decades of precedent in lower courts, because aiding and abetting liability was not explicitly spelled out in that statute.

This afternoon, we're going to explore the implications of the Central Bank decision. We're going to look at how that case might affect the efforts of the SEC to ensure that accountants, lawyers, and other professional gatekeepers do not facilitate fraudulent acts by their clients.

We will also consider the possible consequences of the case for defrauded investors seeking to recover their losses from accountants and attorneys. In assessing the decision's impact and beginning to consider the potential legislative responses, I believe it is very important to remember that aiding and abetting liability in this area has evolved out of case law with no direction whatsoever from the Legislative Branch, the Congress of the United States.

There are some differences in the courts on what the elements of liability are and how they should be applied. Some of the witnesses here today have great concerns about the scope and clarity of aiding and abetting liability as it evolved in the lower courts, prior to the Bank of Denver decision.

Lawyers, accountants, and other professionals should not get off the hook, in my view, when they assist their clients in committing fraud. However, I want to make sure that the law gives clear guidance on what is right and what is wrong. It is our responsibility, in my view, in the legislative branch to do so.

Chairman Arthur Levitt says in his statement today and I quote:

> The Central Bank decision illustrates why it is important to address abuses in the system through legislation, rather than to rely solely on the courts.

I couldn't agree more.

The Supreme Court has laid down a gauntlet for Congress. The tone and substance of the Central Bank decision leave no doubt about that. Some may suggest that Congress could respond to this challenge in a very limited way by simply adding the words "aiding and abetting" into the statute and shipping the matter back into the courts. In my view, if we just act reflexively, I'm confident that we will all be back here again in a few years, if not less, discussing a new, troubling Supreme Court decision on the same subject.

It's clear to me that there's a pattern here. Two years ago, Congress found itself trying to address the Lampf case in which the Supreme Court cut back the statute of limitations for fraud actions to 3 years.

We passed a very narrow bill and that overturned the Court's decision only retroactively. The Court is now considering whether that bill was constitutional, and may very well throw the issue back in our laps.

We are dealing with a Court that is not inclined to interpret anything that we do in this area in a broad manner. Even Justice Stevens' dissent in Central Bank indicated that he would take a very narrow interpretation of any new legislation in this area.

In my view, we need to respond to the Supreme Court's decision promptly and I emphasize promptly. But we must also craft a bill that will not lend itself to a new round of dismemberment by the

Supreme Court. We should take the opportunity to try and flush out the elements of aiding and abetting liability. We need to consider what to do about other related questions that may reach the Supreme Court, such as the scope for other types of secondary liability.

I also believe that we cannot pretend that this issue exists in a vacuum. It is clear that the Supreme Court's analysis in Central Bank and other securities cases has been strongly swayed by a concern about the potential for abuses of the private securities litigation system.

If Congress remains mute on key issues concerning the function of private liability under the securities laws, the consequence will be to continue defaulting to the Court on the nature of the private remedy under Section 10(b) that, in my view, is not a responsible approach and it is not the outcome that I certainly want to see.

Having said that, I will look forward this afternoon to the testimony of our witnesses and the comments of my colleagues, as we review this critically important decision.

Let me turn to my colleagues from Texas and from New Mexico, and Howard, we'll then turn to you for your opening comments.

OPENING STATEMENT OF SENATOR PHIL GRAMM

Senator GRAMM. Mr. Chairman, I want to thank you for holding this hearing.

Senator Domenici and I, at 3 o'clock, are going to have to go over to the Senate floor and debate the budget. Then we will both be back.

I believe, Mr. Chairman, that we have seldom held a hearing on a more important subject than the one we are considering today.

Lawsuits have two effects. One is the intended effect, and that is that they give people the ability to use our system of justice to recover losses that they have incurred due to the fraudulent acts of others.

I think there is a total and absolute commitment to the principle that the functioning of our justice system must give people the capacity to go into court and recover costs that have been imposed on them by improper actions that other people have knowingly undertaken.

Unfortunately, lawsuits have an unintended effect. That effect is that they change the way people do business. They change market behavior, they drive up costs, they disrupt the process of accumulating and creating wealth and generating jobs.

We have seen, in the securities area, the proliferation of lawsuits that have driven up the cost of operating in the equity markets, that have made it increasingly difficult and expensive for small- and medium-sized businesses to give professional assistance. We have seen, I believe, a very substantial market impact. That has occurred, in part, because of the very low thresholds for bringing suit that have existed because of various judgments that have been made by the lower courts. I believe aiding and abetting is a perfect example of that.

I want to review, very briefly, Mr. Chairman, what the decision by the Supreme Court did and what it did not do, not in legal terms, because I am not a lawyer, but in just simple, plain old

street English. The Court continued its basic established position that if you defraud somebody, you are liable. It continued its position that if somebody knowingly participated in the defrauding act, they are liable.

But what the Court also said was that you can't simply, sue someone because someone provided professional services, but they were not involved in the fraud, for aiding and abetting, because the statute does not provide for that liability.

The Court did not remove your ability to sue an accountant, a lawyer, or a securities dealer for malpractice. That right of action still exists. The Court didn't eliminate the ability to sue for fraud. They left open the actions that exist in our common law and in the established principles that we follow in terms of people protecting their rights and recovering damages in civil suits.

The Supreme Court, in my opinion, very wisely decided to remove a liability standard that had not been written by Congress but that, over the years, had been written by judges who wanted to be lawmakers without the inconvenience of having to run for public office.

The Court noted that the aiding and abetting standard might encourage "vexatious" litigation "requiring secondary actors to expend large sums even for pretrial defense and the negotiation of settlements. . . . This uncertainty," the Court said, "and excessive litigation can have ripple effects. For example, newer and smaller companies may find it difficult to obtain advice from professionals. . . . In addition, the increased costs incurred by professionals because of the litigation and settlement costs may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute."

Finally, Mr. Chairman, I think it is very instructive to look at these aiding and abetting cases. They are frequently cases that are filed against people that have deep pockets. They end up being settled in large numbers out of court, where defendants look at the cost of litigating and the cost of paying someone off who is basically engaging in piracy. These defendants frequently decide that it is cheaper to pay tribute than it is to seek justice in a judicial system that is very expensive.

Now I entered this hearing, Mr. Chairman, I hope with an open mind. I do not enter it with an empty mind on this subject.

If somebody's going to try to overturn this Supreme Court decision, they're going to be getting up mighty early in the morning. They're going to be making a very strong case because, quite frankly, I believe this Supreme Court decision is a decision moving us in the right direction.

I think millions of American jobs in the future depend on this issue. I believe that there is a very heavy burden of proof on people who say that we ought to be making it easier to sue people who had no knowledge of the fraud, people who were merely providing professional service, particularly when we already have the ability to sue for fraud, to sue for malpractice.

So I think the Court has made an important decision. I think they have done it for exactly the right reasons. And while I'm certainly going to listen to people who are testifying, they're going to

have to have a very, very strong argument to move me on this subject. I feel strongly about this issue.

This is a big, big issue in terms of the American economy. Our capital market is a very important part of the success of our economy, and one of the reasons that, despite the most absurd actions by Government, the economy continues to perform.

When we hamper the ability of the capital markets to work, we stick a knife in the heart of the American economy. I'm very leery about knowingly allowing that to happen.

Senator DODD. Thank you very much.

Senator Domenici.

OPENING STATEMENT OF SENATOR PETE V. DOMENICI

Senator DOMENICI. Mr. Chairman, I'm not going to have much time because it falls to me to open this debate on the floor.

Mr. Chairman, I've been saying for quite some time, and I'm very pleased that to some significant degree, you have joined with me, or I with you, that Section 10(b) is not working as it should.

And frankly, the Supreme Court said the same thing in the Central Bank of Denver case. In a sense, implied cause of action under 10(b) is a court created creature rule and every element has been developed by the courts.

We're aware of the fact that many of the contentions of this Court with reference to aiding and abetting in terms of vexatious litigation, in terms of settlements being rampant rather than trials because of the nature of the litigation, we're aware of that on a much broader front than this case applies to. This permits us to have another set of very interesting hearings that would permit us to explore just what is going on in our courts.

Frankly, whether you agree or disagree with the decision in Central Bank of Denver it isn't easy to say what the law was prior to the decision. Even Senator Metzenbaum, whom I will not get a chance to hear, but I will read your testimony, I think he might think it's pretty easy to fix this, just return it with some language to where it apparently was before.

I submit that's not very easy at all, because as you now look at that, in order to define secondary liability, clearly we have to have a clear definition of the primary violation. And that too is rather fuzzy. The case law is inconsistent. Predictive statement cases are but one example of this inconsistency. To reverse the Central Bank of Denver decision we need to resolve what the appropriate standard of care should be.

Should the standard be knowing conduct, reckless conduct, or merely negligent conduct? Should it make a difference if the person being sued is an aider or abettor who owed a fiduciary duty to the plaintiffs? What is the appropriate burden of proof? What are the appropriate pleading requirements? The Second and Seventh Circuits have set out rules; other circuits have lesser requirements.

Should there be rights of contribution? And if so, should it be pro rata, or pro tanto basis when settling and non-settling defendants are involved? There's a split in the circuits on this issue too. Should there be proportionate liability under certain circumstances? And if so, what are they? It may be that focusing solely on aiding and abetting liability is only half the fix.

What is the law in view of Central Bank for conspiracy claims under 10(b)? The dissenting Justices stated that they thought that the majority decision abolished conspiracy claims. They also raised questions about the standard for holding employers vicariously liable for the acts of their employees.

There are many unanswered questions. I knew many of these questions existed when I introduced by first job reform bill. I concentrated on one aspect which I had become convinced of, that there were far too many lawsuits filed, that many of them had no real merit, but most of them settled regardless of the merits.

That they were having a big ripple effect, to borrow the Supreme Court's words, for the ripple effect of using litigation to set standards of behavior is certainly not one that is conducive to orderliness and a real sense of certainty about what we expect of people, companies, markets, et cetera.

Mr. Chairman, this is a very fortuitous hearing, as I see it, because we were ready to proceed with a broader based bill, and perhaps some, who thought we could wait, in fact, some might have thought we could wait forever on the Dodd-Domenici bill. I've heard that said before.

I think waiting and delay on Dodd-Domenici is no longer a wise option. Obviously, if we're going to take a real look at this decision. That's not going to be done without a comprehensive examination of and strong movement on the Dodd-Domenici bill to clarify significant aspects of securities class action litigation above and beyond the Denver Bank case.

Thank you very much.

Senator DODD. Thank you very much for those comments, Senator Domenici. I think you properly pointed out the disparity that does exist in several jurisdictions with regard to the standards and there's also the conspiracy elements that were addressed in part by this decision, so the aiding and abetting question is an important one. The standard is an important question and other issues have been raised.

The mere insertion of that language in the statute, in my view, is not enough. We've got to do a more comprehensive job if we're going to do our job thoughtfully and responsibly as we look at this particular question.

So I thank you immensely for your help and backing in other matters.

We're now pleased to welcome our colleague who has, over the years, paid very close attention to these issues. He's certainly no newcomer to them.

Let me just say what I've said on the floor of the Senate. Whether people agree or disagree with Howard Metzenbaum, you will be missed in this institution because you watch these issues so carefully and you pay so much attention to them.

I hope to see you again before this Committee before the fall comes. But if, for whatever reason, it's not the case, I'm pleased and honored that you're here.

Senator METZENBAUM. Thank you very much, Mr. Chairman.

I put my finger up to my good friend, Pete.

Senator DOMENICI. Could I say something about the Senator?

Senator Dodd. Absolutely.

Senator DOMENICI. I don't think very many people know that, at one point, this distinguished Senator was a policeman on the floor of the Senate.

Senator DODD. You're being polite when you call him that.

Senator DOMENICI. I was doing the bills, and for me, he was the policeman. If I once got the matter by him, it was going to pass. Everything had to go by him.

We spent months and months where we would get the support of the majority and get the support of the minority for every amendment thinking that it was all cleared, only to be reminded that a sponsor of an amendment also had to convince Senator Metzenbaum of the merits as well. I must say, occasionally he found something wrong with amendments, and he was right. I'm not saying every day and every time.

[Laughter.]

Senator DODD. He wanted to know if he could have that same privilege next year.

[Laughter.]

Senator DOMENICI. If the Democrats are still in control, he can ask them. If the Republicans are——

Senator DODD. We'll count on it, Pete. I'll tell you.

Senator DOMENICI. If the Republicans are, I think I would say to him, you've done your share.

[Laughter.]

Senator DODD. Howard, welcome.

OPENING STATEMENT OF SENATOR HOWARD M. METZENBAUM

Senator METZENBAUM. Before the Senator from New Mexico leaves, I just want to say that you have been a very effective spokesperson with reference to the question of balancing the budget. This very subject before us today, I respect you for that, because never in the history of America has there been such a hit made upon the national budget as has occurred by reason of the savings and loan debacle where we lost not hundreds of millions but hundreds of billions of dollars and are continuing to lose it.

Part of the reason for some of those losses, a very great part, came about by reason of the aiders and abettors, the attorneys, the accountants, the investment bankers, and they were not nearly as concerned about the ethical proprieties or the legal proprieties.

And I would say to my friend from Texas, who has left, that about 40 to 50 percent of those billions that have gone down the drain went down the drain in Texas, and, therefore, I think there's a special responsibility that all of us have. Each of us comes at this issue from a different way, and I think it is catastrophic, what has occurred in the Supreme Court decision.

As a matter of fact, let me read you, just from the statement of Gibson, Dunn & Crutcher, the law firm that handled the case. In one case, they say that it overruled decades of precedent from eleven Federal Courts of Appeals that had recognized a private cause of action against aiders and abettors.

This case is a dramatic one. It will have a tremendous impact upon the budget of our country and upon the whole question of the American people's reaction to what's fair and not fair.

And let me not pass over, while I was addressing myself to Senator Domenici, Senator Dodd, my grateful appreciation for your comments. You and I have been friends for a great many years. I worked on Pete's Budget Committee. We have, most of the time, been on the same wavelength. Once in a while I had the bad judgment not to be exactly where you were, or vice versa.

Senator DODD. I thought maybe that was coming.

[Laughter.]

Senator METZENBAUM. But I'm very pleased to be here today. And I think the subject of this hearing is of unbelievably great importance, not only to me as a long-time supporter and advocate of strong and effective securities laws, but because it does have a budgetary impact as to what the American taxpayers are going to be called on to pay in so many of these cases.

As you well know, I was on the floor twice in the past couple of weeks, prepared to offer an amendment on this very subject, and you had indicated that you thought we ought to go through the Committee process. And in all candor, I couldn't be more pleased that you didn't say 6 months from now or 4 months from now, but we're here very promptly after those discussions occurred.

But I firmly believe that if the Central Bank of Denver case is permitted to stand, it will weaken more cases, more law, than any other case in the 60-year history of the Federal securities laws. I think it is compelling that we act and act swiftly.

Let me spell out the damage that the Supreme Court's bizarre legal reasoning will cause.

It gives clearly, clearly, I'm not talking about arguable, I'm talking about clearly fraudulent behavior the green light. It says you can't be sued, you can't be held accountable. It immunizes those who have clearly helped others to commit securities fraud.

It says to those who assisted savings and loan executives, BCCI, Drexel Burnham, committing securities fraud, all those people like Michael Milken, who have caused innocent investors to lose hundreds of millions of dollars, go home. You're protected from liability. Sorry to have bothered you. Feel free to do this again.

The surprising 5 to 4 ruling is shocking because it overturns more than 25 years of established Federal court precedents that have permitted private investors to sue aiders and abettors of securities fraud. Every single circuit that has addressed this issue came to the opposite conclusion from the Supreme Court, and the Supreme Court arrived at its decision by a 5 to 4 ruling.

But that decision is much more than just a bad decision. This case undermines fundamental protection for investors and the securities market. It is, on its face, unfair. If you're helping somebody rip off some other group of people or the Government, whatever the case may be, there isn't any reason under the sun that the law should protect you from being held responsible or liable.

Investors have long had the right to sue their lawyers, their accountants, whether theirs or others, in most instances others lawyers, sue lawyers and accountants, bankers, brokers, and others who assist others in committing securities fraud. This right of action played a vital role in compensating swindled investors in the major financial frauds of the last three decades.

Innocent victims who lose money and sometimes their life savings in fraudulent securities schemes have recovered hundreds of millions of dollars from aiders and abettors. Just recently, 23,000 bondholders successfully sued the lawyers and accountants in a savings and loan case and recovered $275 million. If this ruling had been on the books at that time, it would have wiped out the recovery. Investors would not have recovered a penny.

Unless this Court decision is reversed by Congress, most defrauded investors will not recover their losses because, typically, the perpetrator of the fraud is insolvent by the time the case filed and completed. If you can't go against the accountants, the investment bankers and the lawyers, too often the malefactor himself or herself is no longer collectible.

For example, the cheated investors that recovered the $275 million in the case I just referred to, had won $1.5 billion judgment against the executives directly responsible. But that judgment was uncollectible because they had no money left.

In addition, this case also cast doubt upon the SEC's own ability to go after aiders and abettors. About 15 percent of the SEC's enforcement actions include charges of aiding and abetting. In those cases, the established right to proceed against aiders and abettors is critical to effective enforcement.

Finally, the Central Bank decision severely weakens the deterrence of securities fraud. There isn't any argument about that. All these people seated out here today aren't those who are the plaintiffs' lawyers and advocates and concerned about them. They're concerned about the investment bankers and the accountants the lawyers and whether or not they may be sued, and think that this is a great bonanza if it stays as is.

This decision sends a dangerous signal to the securities markets that a primary enforcement tool has been eliminated. That includes all the independent bankers, accountants, and attorneys. It not only hurts defrauded investors, it hurts all investors. It hurts the United States Government's own pocketbook.

It is imperative that Congress act swiftly to rectify this situation because the Central Bank decision already is having immediate implications in a huge number of fraud claims. As we speak, people are writing up motions to dismiss and reopen cases. At least one major fraud case has already been dismissed. A judge has thrown out a $70 million lawsuit by the shareholders of the bankrupt Bonneville Pacific Corporation against the accountants for the company who allegedly misrepresented the company's financial condition and who are now off the hook. That isn't right.

Former general counsel of the SEC, who is now a prominent securities defense lawyer, has said,

> I am recommending to clients that if they've settled a case in the past with the SEC under aiding and abetting, they could get out of any injunctions.

A major defense law firm, Gibson, Dunn & Crutcher, has alerted its clients in a special dispatch, quote:

> There are reports that legislation will be introduced in Congress in response to the Court's decision. Therefore those clients who are defendants in Section 10(b) cases involving private claims that allege aiding and abetting should immediately seek a final judgment dismissing those claims to minimize the impact of new legislation.

Another major securities defense firm, Fried, Frank, sent an alert to clients to reopen injunctions based on aiding and abetting, move to dismiss current SEC aiding and abetting cases and take the position that Central Bank wipes out all forms of secondary liability under all provisions of the Federal securities law.

Obviously, the Central Bank decision has opened a Pandora's's box of securities fraud. We must slam it shut.

I can't urge you strongly enough, Mr. Chairman and Members of the Committee, and I can't tell you how pleased I am to see that the Chairman of this overall Committee has joined this hearing. I urge the Banking Committee to act immediately to amend the Securities & Exchange Act of 1934, restore the right of private plaintiffs, reserve the right of the SEC to sue aiders and abettors of securities fraud.

As you know, I've already drafted legislation to achieve that goal. I agreed to withhold offering it as an amendment to bills pending on the Senate floor so that you and your Committee could review the devastating impact of the Supreme Court decision.

I hope we can work together as expeditiously as possible to move this legislation through the Senate. I would prefer that route, but delay can be so costly that if the Committee does not see fit to act promptly—and I don't say this as a threat, I say it because I was prepared to do it before the Committee here. If the Committee doesn't see fit to act promptly, I know that I will be offering an amendment on the floor.

I hope the Committee will take this issue up, move with dispatch, protect the American taxpayer, protect the little individual investor in various kinds of stock investments or other kinds of investments. I think there's no more important piece of legislation from the standpoint of securities and the securities market than this one, and I'm grateful to you for according me as much time as you have.

Senator DODD. Not at all, Howard. We thank you for being here.

I have a question or two for you, but before I do that, let me turn to our Chairman here of the Committee for any opening comments he may have.

OPENING STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. Thank you very much, Chairman Dodd.

Let me begin by commending you for moving quickly to establish this hearing to assess the implications of the Supreme Court's Central Bank of Denver decision.

As you are, I am also concerned that this decision unduly restricts the remedies available to investors and the enforcement capabilities of the SEC. I think we do have to determine whether to reinstate the aiding and abetting liability under the anti-fraud provisions.

I also want to thank Senator Metzenbaum for coming. I know he's given a detailed statement which is an expression of an interest that he's shown many times in this area. It's very helpful to this Committee to have you take that interest and role with us. I appreciate that effort and leadership.

I think it's important to note that the United States, is fortunate to have the most liquid and the most efficient capital markets any-

where in the world. It almost goes without saying that the strength of our markets rests in very large part on the faith investors have that they can seek redress in cases of fraud.

The SEC's Director of Enforcement testified on behalf of the Agency last year before this Subcommittee saying:

The implied private right of action under Section 10(b) and Rule 10(b)(5) thereunder, is critically important to the effective operation of Federal securities law.

Today, we will consider whether the Supreme Court's decision in the Central Bank case, by holding that investors cannot sue aiders and abettors under that implied private right of action in fact jeopardizes the efficient operation of the securities laws.

We're going to hear Arthur Levitt, Chairman of the SEC, among other important expert witnesses, on this issue.

Writing for the four dissenters, Justice Stevens criticized the five member majority for, quote:

Reaching out to overturn a most considerable body of precedent.

Prior to Central Bank, courts in every circuit in the country had recognized the ability of investors to sue aiders and abetters of securities frauds in literally hundreds of cases, a point I assume Senator Metzenbaum made in his testimony before I arrived.

So we will hear today from many, including Chairman Levitt, as to how we might address the Central Bank case here, what can be done, in his view, and the degree to which legislation would be the preferred vehicle.

In addition, I've received a detailed letter regarding this case in securities litigation from Professor Joel Siegelman of the University of Michigan Law School, who is one of the Nation's experts on Federal securities laws, and was here as a witness before this Subcommittee last year. That letter describes the Supreme Court decision as, quote, "regrettable," and expresses his concern that the Supreme Court decision may jeopardize investor confidence in U.S. securities markets.

He wrote further:

There is insufficient evidence at this time to justify legislative changes that will further burden private Federal securities litigation.

In any event, I ask unanimous consent, Mr. Chairman, that his letter be made a part of the record.

Senator DODD. Without objection.

Senator RIEGLE. I'd like to make another observation.

We don't have too many hearings in the afternoon. We're in the midst of a very intense series of discussions today, as a matter of fact, on health care reform. I serve on the Finance Committee, as you know, as the Chairman of the Health Care Subcommittee. We will be meeting literally within minutes on a very important point in these discussions, so I must leave to go and attend to those duties.

But I'm struck by the turnout here in the room, Mr. Chairman. This is not a garden variety problem. There are a lot of very expensive meters running here in the room today.

[Laughter.]

Senator RIEGLE. This afternoon.

It's always interesting when I look out, whether I see half the gathering of school children that have come to visit the Capitol and are filtering in and out of a hearing, and then when I look out and

I see a sea of very well-dressed and prominent professionals, particularly in the mid-afternoon, and the press table largely filled, then you know you've got a big dollar item on the table.

Senator DODD. That's because you came by.

Senator RIEGLE. I'm not quite sure of that. But in any event, I think it's another way of noting that there are billions of dollars at stake here. The whole question of how the markets work and whether they work fairly and what happens to people who are defrauded is a very important issue. It's an important public policy issue, it's an important dollars and cents issue, and this turnout today is an expression of that.

So I think its entirely appropriate that we be focused on this, and I want to say again how much I appreciate your leadership, Chairman Dodd, in stepping up to the plate on these issues as you always do.

Senator DODD. Thank you very much, Mr. Chairman. I appreciate that, and understandably you can't be here with us this afternoon, but this is a very important matter. And the reason we held the hearing as quickly as we did is because it needs to be addressed. Time is moving in this Congress, obviously. My concern is that we do it properly and we do it comprehensively.

Howard, I just have a couple of questions.

Senator METZENBAUM. Could I just add one thing?

Senator DODD. Certainly.

Senator METZENBAUM. I very much appreciate the fact that the overall Chairman of the Committee is here this afternoon and is interested in this subject.

I just want to say that the three of us, and not only the three in this room but there are other Members of the Senate who feel the same way, we've often times been out on that floor fighting for $50 million, $6 million, $100 million, for some program to help children, to help the handicapped, to help the schools, whatever the case may be.

I want you to know if we don't do something in Congress on this basis, we will be taking $312 million and giving it away because the firm of Deloitte and Touche, a major accounting firm, has already agreed to pay $312 million to settle over a dozen FDIC and RTC lawsuits. The firm was charged by those two agencies with having issued clean audits for banks and savings and loans that were on the brink of failure. The agreement was made.

Senator DODD. I don't think anyone's arguing. You may have an argument with Phil Gramm about whether or not you ought to have any legislation passed.

The question though is whether or not we're going to have it done in a way that will be comprehensive. I'm unwilling, and I'm curious to your reaction, if it's just a question of inserting the words "aiding and abetting" into the statute; do you think that's enough?

Senator METZENBAUM. I don't want to try to spell out the language of it, but I don't think we ought to broaden the subject beyond dealing with this one particular case because there's such a sense of urgency while cases are being dismissed. And once they're dismissed, the ball game is over.

But whether or not we just insert the words "aiding and abetting" or whether we do it in some other language, but I'm prepared, Mr. Chairman, to drop everything to work with you to do what has to be done later today, tomorrow, the next day, whenever you want, and I'm sure there are others who would be very willing to do the same.

Senator DODD. I thank you, Howard.

Senator METZENBAUM. Thank you, Mr. Chairman.

Senator DODD. Let me invite the Chairman of the Securities and Exchange Commission to join us.

Mr. Chairman, we appreciate your willingness to be here today. Thank you for taking the time. We're anxious to receive your testimony. We'll be happy to include in the record your testimony and any supporting documents or other information you think may be helpful to the Committee.

STATEMENT OF ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ACCOMPANIED BY: SIMON LORNE, ESQUIRE, GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Chairman Dodd, Chairman Riegle, Members of the Subcommittee, I greatly appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding the Central Bank of Denver decision. With me today is Simon Lorne, General Counsel of the Commission.

As you know, the Supreme Court has decided that private investors cannot sue persons who aid and abet violations of section 10(b) and Rule 10(b)(5) of the Securities and Exchange Act. The decision means that private investors may no longer be able to recover from persons who contributed to a securities fraud even if they act knowingly or with a high degree of recklessness. The decision also creates uncertainty about the SEC's ability to use the aiding and abetting theory where it is not expressly provided by statute. We believe that Congress should legislate to address the Central Bank of Denver decision.

The Central Bank of Denver decision did not specifically speak to SEC enforcement actions. Arguably, the Court did not intend to restrict the Commission's ability to pursue aiders and abettors, and we may choose to make these arguments in perhaps one or more selected cases. Because other enforcement options are available, however, we do not believe that we should devote substantial resources to litigating this issue in each and every instance. To do so would simply create more uncertainty, and the diversion of much needed resources would reduce the effectiveness of our overall enforcement program.

Thus, at this time, we will generally refrain from asserting aiding and abetting theories of liability, where the statute does not expressly provide for such claims.

I feel confident that our enforcement program is going to continue to operate effectively. The decision does not create a major hole in the program because an enforcement remedy will almost always be available against defendants that we previously would have pursued under an aiding and abetting theory. In many cases, we should be able to charge primary violations or use other forms

of secondary liability. We also will make extensive use of our administrative authority to enter cease and desist orders against persons who cause violations by others.

Although these alternatives will permit us to operate effectively, our enforcement options will be limited in certain types of cases. For example, penalties are not available in administrative proceedings other than against regulated entities. If we have no choice but to proceed administratively against a person who assists a fraud, the sanction in some cases may be too mild. We also will inevitably be confronted with cases in which we will have to litigate on two fronts: In Federal court against the primary violators, and then administratively against other participants. This would consume more of our resources than in similar cases in the past.

Four years ago, this Subcommittee took a leading role in advancing the Remedies Act, which greatly increased the strength and the flexibility of our enforcement program. Congressional action is needed now to preserve the benefits of that legislation.

Legislation is also needed to restore aiding and abetting liability in private actions which are a necessary supplement to our overall enforcement program. They serve to deter securities fraud and to compensate injured investors. In fact, the Central Bank of Denver decision may affect private securities litigation even more severely than our enforcement program. We may use administrative remedies to reach aiders and abettors. The private parties may have no alternatives, at least under Federal law.

We also recognize that this Subcommittee is considering other policy issues raised by private litigation under the Federal securities laws. Efforts to improve the securities litigation system are important, very important. The Commission will continue to support measures that are carefully crafted to achieve this goal. The Central Bank of Denver decision deserves your particular attention because it has fundamentally curtailed well-established and vital investor rights.

As I stated earlier this year, our private litigation system will not serve its intended purposes it if fails to distinguish between strong cases and weak cases. Central Bank illustrates why it is important to address abuses in the system through legislation rather than to rely exclusively on the courts. Judicial decisions of this type are blunt instruments, reaching results that affect broad categories of cases without regard to their merits. They are not, in my opinion, a substitute for legislation that is carefully tailored to ensure that it does not affect meritorious cases.

We're also dealing with these policy issues at the SEC. Two months ago, I announced the creation of a Consumer Affairs Advisory Committee in order to create a channel through which we can better address the needs of investors in their roles as consumers of financial services and products. Too often, one side or another uses consumerism as a means to substantiate their arguments. We intend to deal directly with these consumers to explain to them what the issues are, where their interests remain, and hear back from them what their genuine concerns are.

This Committee has a diverse membership: Representatives of investor organizations, national consumer advocacy groups, corporations, financial service firms, labor unions, State security regu-

lators, shareholder relations specialists and financial service professionals. Among the members are Helen Boosalis, former Mayor of Lincoln, Nebraska, representing AARP; Tom O'Hara of the National Association of Investment Clubs, and the National Association of Individual Investors; Bonnie Hill, Dean of the University of Virginia's, School of Commerce, Ann Jordan; Peter Lynch; and Chuck Schwab.

Because the ability of private plaintiffs to assert their rights in cases of fraud is so fundamental to any scheme of investor protection, the first issue that this Advisory Committee will consider, when it meets 2 weeks from today, will be securities litigation in the wake of the Central Bank of Denver decision. They're going to discuss suggestions for the reform of the litigation system, including some of those before this Subcommittee.

These are very complex issues.

I'm sure that this Advisory Committee will be exploring their various facets for some time to come.

As a forum, the Advisory Committee is ideal. Its diversity will ensure both a lively exchange of ideas and opportunity for all sides to be heard, and a means of preventing their being used and manipulated to prove the arguments for one side or another.

Mr. Chairman, I'd be glad to address any questions that you and your colleagues may have.

Senator DODD. Thank you very much, Mr. Chairman. Let me commend you for the establishment of your Consumer Affairs Committee. Is that the proper title?

I think that's a very positive suggestion, and I think the rationale for it is well-articulated and well-founded.

As someone who sits behind this side of the table, I've never heard anyone offer an amendment on a tax bill that wasn't going to save money or produce revenues, and I've never heard anyone get up and offer a proposal in the area of securities litigation that wasn't consumer friendly in any way.

It will be helpful to have such a Committee to assess the impact of these decisions. I'm particularly pleased that you're going to ask this Committee to take a look at the broad issue as well as the one before us today of litigation reform.

I thank you for that.

Mr. Lorne, we welcome you as well to the Committee here today.

Mr. Chairman, you noted in your comments, and I'm quoting from page 7 of your testimony, that it's no longer safe to assume that if there is a gap in the securities laws, the Supreme Court will supplement the statutory text to effectuate Congress' underlying policy goals. I totally agree with that assessment.

It would seem further, to me, that this point counsels against merely inserting the words. What I'm fearful we'll end up with, is an amendment just to insert the words of "aiding and abetting" into a statute. I wonder whether or not you agree with that note of caution that I've just expressed?

Mr. LEVITT. I do agree. The issue is a broad issue. It has many ramifications. And I think that merely to do that doesn't do justice to it. I think what's key here is the mission of the Commission, among all the responsibilities that the Commission has, nothing is

more sacred, nothing is more important than protecting investor interests.

In my judgment, the Supreme Court decision makes it more difficult for the Commission to pursue that. And I think it's terribly important that we address this in every way possible. What we do as a Commission, what you do in the Congress should address that as quickly as possible. At the same time, I think we've got to do it thoughtfully and we've got to be mindful of the ramifications that are involved.

Senator DODD. I'd suggest, just as quickly, that there is the danger of going the other way to get so detailed in a piece of statutory language that it constricts the Court. I presume you might agree with that conclusion, as well.

Mr. LEVITT. Yes, sir.

Senator DODD. What I'd like to ask you to do is take a look and submit to us some draft language. I'll also be asking other witnesses to do this.

Mr. Lorne, maybe I ought to address this to you as legal counsel here, as well as to the Chairman, as Chairman of the Commission. I do not want to make the assumption that because you submit the language that it's going to be part of the statute, but we'd like your advice and counsel as to how to proceed along those lines. If I may make that request of you, and sooner rather than later would be helpful.

Mr. LORNE. Fine.

Senator DODD. Your testimony, Mr. Chairman, further suggests that even if the Central Bank decision applies to the SEC, the SEC has other legal tools at its disposal which may fill the gap. Would it be fair to say that the decision is not likely to have a direct affect on the SEC's enforcement authority?

Mr. LEVITT. I think that's true. I think the Commission can make certain adjustments. But I make mention of the fact that clearly the reason why the Commission is so uniquely effective—why we are looked upon by every nation in the world that is thinking of establishing securities markets, as kind of a mark of their arrival in the international field of capital markets—is because we are successfully able to mobilize not merely the resources granted to us by the Congress but also to make use of the efforts of self-regulatory organizations and the private attorneys general that work with us collectively to deter wrongdoing.

And that sensitive changing partnership is a splendid way of doing a job that Government couldn't and shouldn't do by themselves. I think that's the spirit that we wish to preserve by seeing to it that we don't do anything to deny that private right of action. That's why we come to you and ask the Congress to address this issue.

Senator DODD. I appreciate that.

Let me step back.

I mentioned earlier the language of the statute. I wanted to ask you an additional question relating to the issue of standards.

I pointed out in a discussion with Senator Domenici, which I think you were in the room to hear, that we have different standards that have been used in various courts to enforce the notion of aiding and abetting. I wondered if you had any particular thoughts

or ideas that you wanted to share with the Committee today on those standards; how we might define those standards.

Mr. LORNE. Senator, if I might, I think that's an important issue to address.

You'll recall that when Central Bank first came up to the Supreme Court, it was to examine the standards initially and led to a decision that there wasn't a private right of action at all. At that time, we were of the view that the recklessness standard was an appropriate standard for liability. Certainly that is a question that should be addressed in any legislation responding specifically to the issue.

Senator DODD. That would go to the question of knowledge.

Mr. LORNE. Correct. I think anybody acting recklessly with respect to fraud, and aiding and abetting that fraud recklessly, probably should be subjected to liability under those circumstances in the overall context of some sort of response.

Senator DODD. As opposed to general awareness which is the other standard that's been used.

Mr. LORNE. I think that's probably right. I must emphasize probably. These are questions that the Commission has not dealt with.

Senator DODD. Would you agree, Mr. Lorne, that it's probably important for us to add some language so that we don't leave that decision to the courts, given the propensity of this Court to disregard entirely decades of precedent, in a very literal application of the law that there was no such language of aiding and abetting attending these statutes.

Mr. LORNE. I would think, when we know there's a question that got to the Supreme Court last time, we ought to resolve that question at the same time as we resolve other issues.

Senator DODD. I appreciate the answer.

Arthur, let me return to you, if I may.

It seems to me that one of the biggest impacts of the case on the SEC may be that if private parties cannot police the conduct of professionals, the SEC will be under a lot of pressure to bring more cases against professionals.

I wonder if you might comment on the pressures on the SEC's resources.

First, you indicated that you may disregard most of these cases. If that's not the case, what are the resource implications?

Mr. LEVITT. I think there's still some fuzziness about the implications of this, and I can't tell you with absolute certainty, except to say that our conclusions at this point are that the decision will impact a certain number of cases. We intend to make some adjustments to accommodate that.

But going forward, we just would be handicapped. You'd be taking away a very important tool from us.

Maybe I could be a little bit specific about it, because I don't know that people adequately understand the implications of what aiding and abetting may be. For instance, the lawyer who drafted the disclosure documents and closed his eyes to his client's fraud may be perceived by a court only as an aider and abettor. Or the salesmen who helped attract millions of dollars to get-rich-quick schemes as to which they weren't the architects—they were just out there hustling this stuff—they're going to be helped by this de-

cision. And the person who is enlisted to send a false confirmation to an auditor saying the inventory was in the warehouse, that kind of person will welcome this decision. So that just gives you some specifics in terms of the scope of this.

Senator DODD. I brought up this point the other day during the consideration of the nomination of one of your colleagues.

Mr. LEVITT. Steve Wallman.

Senator DODD. I think he's a very fine nominee.

It had been reported in the Wall Street Journal that day, that there were at least 10 cases that the SEC was going to drop the charges on in the aiding and abetting area.

Because of the obvious concerns that this decision reached into the SEC's ability, in addition to the issue of private legal rights, I expressed my concern. I didn't want to see the SEC not test this.

Those who have drawn a conclusion that this decision also affects the SEC's actions may be right, but I don't know that. It's a matter, in my view, that would have to be adjudicated. I would hope we can try to get an answer here rather than just make an assumption that it's the case.

Mr. LEVITT. Out of the 400 cases that we have now pending, I guess about 80 to 85 of them rely on aiding and abetting.

Senator DODD. As a part of the charges.

Mr. LEVITT. As part of the charges.

Senator DODD. Very few cases are just aiding and abetting cases.

Mr. LEVITT. I think there are about 25.

Senator DODD. Just aiding and abetting.

What are you doing in those cases? Are those the ones you're dropping altogether?

Mr. LEVITT. No, I don't think so. We're looking at them very carefully but we're clearly not dropping all of them.

Mr. LORNE. Senator, you've got to realize that historically the distinction between primary liability and aiding and abetting liability was simply not that great. As a result, we weren't focusing and the courts weren't focusing as much on the difference between the two.

We think that some large number of the cases that just allege aiding and abetting can be brought with other charges or can be brought administratively instead of in the courts under a causing violation. So we think a very large number, and perhaps all of the cases, could be brought under other methods.

Senator DODD. The reason I bring it up, is that Senator Metzenbaum has expressed his sense of urgency. You also heard my colleague from Texas.

Most of you are knowledgeable about how this institution works. We've got a lot on our plate in the coming 15 weeks of this session of Congress, and we're not back again until next January. Then it's a new Congress and we have to get underway again.

It's not beyond the realm of possibility, despite my desire and the desire of Senator Metzenbaum and the majority of this Committee to move forward and do something in this area, that we may get sidetracked, despite good intentions and good efforts. Then you've got to get it through the other chamber as well.

I'm not suggesting we won't be able to get it done, but I think it's important to suggest to you that we may have our problems.

My concern is that if the SEC decides to not test the aiding and abetting question from its own enforcement capabilities, we may regret it in a few months if we've been unable to act.

I would hope there may be some cases that are fairly ripe that are moving where that matter may get to the court before we're apt to act. I think that would be helpful. That's one Senator's opinion; you may hear differently from others, but I'd be curious to your reaction.

Mr. LEVITT. I certainly think that we intend to look at those cases very, very carefully and see which ones may be appropriate for us to do something about. I think you've put your finger on something when you spoke about resources.

In the absence of having private action available to us in this arena, more resources clearly are going to have to be going to the Government to do it. And that's not the best way, in my judgment, to accomplish a goal that I think has been handled with efficiency and has really maximized the use of minimum resources.

Senator DODD. I'm sensitive to that as well. I know you're hard pressed, and I'm not expecting you to take on all the burden.

I don't want the principle of law, to get lost and have everyone say, well, gee, you guys didn't get it done in Congress and we just didn't bother with it, and find we've left this gaping hole here.

I am more interested, at this particular juncture, in making sure that that principle of law is tested.

Mr. LORNE. We are looking carefully at the cases we have, the cases that are in the Courts of Appeals, and thinking about appropriate cases in which to pursue the arguments. We have some concern that given the Central Bank decision, it's clearly true that the issue of enforcement actions for aiding and abetting won't be resolved short of another Supreme Court decision, and that's going to take some years, unfortunately.

Senator DODD. You may be right on that and I appreciate that. I don't think we're disagreeing with each other at all.

I wish you'd keep us posted. It would be very helpful to the Committee to be aware of how you're progressing. I don't think we need to know the details of cases but rather how you're proceeding with challenging or testing this particular——

Mr. LEVITT. We'll keep the Committee advised.

Senator DODD. I appreciate that immensely.

I've got about 6 minutes to record a vote.

I don't have any additional questions for you. Your testimony is very helpful. I will look forward to working very closely with you in the coming days to see if we can't put together some language.

Again, you've already heard it expressed here that, there'll be some significant opposition. My view is we should try and deal with this issue now.

I thank you immensely for coming and sharing your thoughts with us. We look forward to working with you on this issue, and we'll be very interested, Arthur, in hearing the comments from your Consumer Affairs Committee on the litigation reform issue.

I thank you.

Mr. LEVITT. Thank you, sir.

Senator DODD. There may be some additional questions by other Members for the Chairman of the SEC, and if so, we'll leave the record open on that point.

I'll have the Committee stand in recess for about 10 minutes until I come back, and we'll then invite the second panel to join us at the Committee table.

[Recess.]

Senator DODD. The Committee will come to order.

Let me apologize to all of you for delaying with the Budget Committee.

Let me just briefly introduce our second and final panel here. Mark Griffin, Director of Securities Division within the Utah Department of Commerce. Mr. Griffin has jurisdiction under Utah's Blue Sky Law to regulate and offer the sale of securities. He's twice been elected a member of the Board of Directors of the North American Securities Administration Association, and currently serves as the Association's treasurer. Donald Langevoort. Did I pronounce that correctly?

Mr. LANGEVOORT. Langevoort.

Senator DODD. Mr. Langevoort, excuse me, has been associated with Vanderbilt Law School since 1981, and is currently the Lee S. and Charles A. Speir Professor of Law there. He has served as special counsel at the SEC and was an associate at Wilmer, Cutler & Pickering, and has written extensively on the issue.

Stuart Kaswell is the senior vice president and general counsel of the SIA, in charge of overseeing the Association's legal staff in Washington and New York Offices. Prior to joining the SIA in January 1994, he practiced securities law at Winthrop, Simpson, Putnam and Roberts in Washington. Before that, he was Minority Counsel to the House Energy and Commerce Committee and began his career at the SEC.

Harvey Goldschmid has been a Dwight Professor of Law at Columbia University since 1984 and has been associated with that university since 1970. Prior to teaching, he was an associate at the New York law firm of DeBevois—is that how you pronounce that?

Mr. LANGEVOORT. DeBevois.

Senator DODD. DeBevois, excuse me, and Plimpton from 1966 to 1970. He has written several books and numerous articles, was the counsel of record on the brief filed by the Bar of the City of New York in the Central Bank case.

Eugene Goldman is a partner in the Washington, DC office of McDermott, Will & Emery, and has represented clients before the SEC in securities cases including class action suits brought against directors and officers, and previously served as the attorney and senior counsel in the SEC Division of Enforcement from 1977 to 1983.

David S. Ruder is a partner in Baker, McKenzie's Chicago Office and Professor at Northwestern University School of Law. He served as Chairman of the SEC from 1987–89, and was a public member of the Board of Governors of the National Association of Securities Dealers. Mr. Ruder has written several law review articles pertaining to the issue at hand.

Glad to have all of you here today. Mr. Langevoort, why don't you begin and then go to Mr. Griffin.

STATEMENT OF DONALD C. LANGEVOORT, LEE S. AND CHARLES A. SPEIR PROFESSOR OF LAW, VANDERBILT UNIVERSITY

Mr. LANGEVOORT. Thank you, Mr. Chairman.

Senator DODD. I want to ask you too, by the way, if you'd help me out here. I realize you may have voluminous material to provide to the Committee. If you could try, and I realize hearing this from a U.S. Senator is always educational but, if you can try to limit your remarks to about 5 or 6 minutes apiece, you'd really make this Committee very happy so we can get to the questions.

Any material you have, we'll include in the record.

Mr. LANGEVOORT. Thank you, Mr. Chairman.

Let me try to set an example for the rest of the panel by doing it in less than 6 minutes.

Senator DODD. Very good.

Senator GRAMM. His picture goes in.

[Laughter.]

Senator DODD. The next time we have a hearing, you'll go first on this.

[Laughter.]

Mr. LANGEVOORT. The Supreme Court's decision in Central Bank of Denver vs. First Interstate Bank is a dramatic constriction of the scope of Rule 10b–5, private rights of action, but it may seem more dramatic now than its impact will ultimately turn out to be.

We are told that there's no longer any private aiding and abetting liability under Rule 10b–5. But at the end of the opinion, the Supreme Court also told us that no one is stopped, whether the SEC or a private plaintiff, from charging a person with primary responsibility under the Federal securities laws.

And indeed, the Court—if you read its opinion very carefully—invited a definition of primary liability that effectively says that anybody who commits a fraud or is a substantial participant in the fraud itself can be charged.

I did a fairly brief review of the case law of 1993 under the law of aiding and abetting. I looked at those cases, and asked myself, could they be recharacterized readily as primary violations? The answer in over half of them was, yes.

So my sense is that the Supreme Court has begun a dialog with the lower courts that by no means is going to be ended by this decision. Indeed, the lower courts are going to respond by working out a sensible definition of primary liability. It will continue to capture those who actually are responsible for fraud.

That brings us to the policy question before the Committee. What to do?

If my prediction that primary liability is indeed a fairly broad concept is right, then there probably is time to consider this issue in tandem with the broader policy questions relating to securities litigation reform in this country.

I believe that aiding and abetting should be sanctioned both in SEC enforcement actions and in private rights of action, but I don't think aiding and abetting should be reinserted back into the securities law without, at the same time, trying to address the distorted incentives that we have today that have led to some extent to ex-

cessive litigation, to lack of merit in some actions, notwithstanding the positive attributes of aiding and abetting liability.

I think the issues that are raised by S. 1976, the bill that, Mr. Chairman, you introduced with Senator Domenici, raises many of the issues that have to be addressed in thinking about what the proper scope of aiding and abetting liability is in private rights of action.

And I don't think you ought to separate the question of whether there should be aiding and abetting from the more general question of litigation reform. Thank you.

Senator DODD. Thank you.

Mr. Griffin.

STATEMENT OF MARK J. GRIFFIN, DIRECTOR, SECURITIES DIVISION, UTAH DEPARTMENT OF COMMERCE, ON BEHALF OF NORTH AMERICAN SECURITIES ADMINISTRATION ASSOCIATION

Mr. GRIFFIN. Thank you, Mr. Chairman and other Members of the Committee.

Mr. Chairman, on April 19, 1994, the Supreme Court struck a devastating blow against investors who are victims of securities fraud. We've heard many comments about that today, and I'm presenting you a point of view that is exactly 2½ blocks from Main Street, USA. That's where my office is, and I've come a long way which admittedly is a long way from Wall Street.

As the dissent amply points out in this decision, the decision runs directly counter to some three decades of practice, hundreds of judicial administrative proceedings, and precedent in all eleven Courts of Appeal.

Importantly, and as you have already heard today, the decision also jeopardizes the ability of the Securities and Exchange Commission to prosecute aiding and abetting claims in its own cases.

The Commission, as we've already heard, has already voluntarily started dropping aiding and abetting cases, in some cases based on the Central Bank decision.

At the same time, defendants who have been charged with aiding and abetting are moving to have private cases dismissed and verdicts overturned. In fact, some of that has already taken place. Other defendants in aiding and abetting cases are being advised by counsel to move immediately to seek final judgment dismissing those claims to minimize the impact of any potential legislative response.

This is a state of affairs that must not go unchallenged. NASAA respectfully encourages you to deal immediately with the narrow, straightforward, and pressing problems caused by the Central Bank decision. We urge you to resist attempts to hold off on drafting legislation to correct the situation until such a time, if ever, that a consensus emerges on the broader issues and that present themselves to us with respect to litigation reform.

We do not need to reorganize the fire department before we put out this four alarm blaze now threatening small investors. An important lesson to be learned from the large financial frauds of the 1980's is that these schemes often involve not only the primary wrongdoers who are central to the fraudulent enterprise, but also

the professionals, the lawyers and accountants, who aid and abet the fraud.

In many instances, these financial crimes could not have succeeded without the active participation of the accounting firms and law firms that conferred credibility and advice upon the enterprises.

Given that the financial frauds of the 1980's vividly demonstrate that professionals play a key role in facilitating financial crimes and financial fraud, why in the 1990's should we want to limit the liability of such individuals? It simply doesn't make sense.

I would like now to turn to what NASAA believes will be the practical effects of the Supreme Court decision if it's not corrected by Congress. Among others, we should expect the following results: Reduced accountability of professionals and a green light for more 1980's like abuses. Diminished recovery for defrauded investors. Greater strains on the already overburdened SEC and state regulatory agencies. Ripple effects threatening other forms of secondary liability and a possible erosion of investor confidence resulting in less capital available to U.S. businesses.

The reality is that investors now will be forced to rely on redress opportunities that may only be available under state statutes, rather than relying on a uniform national standard.

The chart I've brought with me today illustrates some of the problems with relying on these State statutes. As you can see, the chart to my right indicates somewhat of a patchwork quilt with respect to aiding and abetting under State Blue Sky Law.

In some instances, the States have judicially expanded aiding and abetting liability similar to the conditions precedent to the Central Bank decision. Other states have legislatively included something in their statute about aiding and abetting liability. The vast majority of the states have no judicial interpretation of a uniform statute, and so that's somewhat ambiguous. And so on and so forth.

It's important to keep in mind that in its Central Bank decision, the Supreme Court invited Congress to look at this issue and legislate in this area. I would encourage you to accept this invitation, and to move immediately to enact limited legislation to reverse the decision and to explicitly restore the authority under Section 10(b) and Rule 10b–5 for the SEC and private litigants to bring appropriate actions against persons who aid and abet securities fraud.

I'm afraid that under the alternative scenario in which Congress does not act, we would be forced to face up to this inaction when defrauded investors demand to know why they cannot be made whole.

We will have to admit to such investors that, yes, you may have been defrauded. Yes, some other person may have materially assisted the primary violator, perhaps even opening the door for the primary violator to have committed the illicit act. And this assistance may have taken place openly, yes, recklessly, and maybe even with substantial personal benefit. No matter how unfair this may seem to you, Federal law places this secondary violator beyond your reach. And this is not a conversation I want to have with a defrauded investor, particularly when there's an opportunity to correct the situation.

Thank you, Mr. Chairman.
Senator DODD. Thank you.
Mr. Kaswell.

STATEMENT OF STUART J. KASWELL, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, SECURITIES INDUSTRY ASSOCIATION

Mr. KASWELL. Thank you, Mr. Chairman. Chairman Dodd, Senator Gramm, Senator Domenici. On behalf of the Securities Industry Association, I'd like to thank you for the opportunity to testify today.

I'm Stuart Kaswell, general counsel of SIA. It's a pleasure to be with you today to present SIA's views on the important topic of aiding and abetting liability under Rule 10b–5.

I ask that a copy of my statement be included in the record.

Senator DODD. Without objection.

Mr. KASWELL. The securities industry plays a critical role in the life of our economy. Our industry matches investor with entrepreneur, saver with industrialist. We risk our own funds on a regular basis to bring new issues to market and to provide markets that are liquid and deep.

In 1993, SIA's members raised over $2.4 trillion. Our capital markets create new jobs and new products that affect every facet of our lives. Our markets are the broadest, biggest, and the most honest in the world. Unlike so many other industries where U.S. firms have played catch up, the U.S. securities industry continues to set global standards for innovation, honesty, and profitability.

Inevitably, in an industry of our size and diversity, there may be a handful of bad actors. When these very few individuals defraud investors, SIA strongly believes that those investors should be compensated fully and swiftly.

The Federal securities laws provide many tools for both private investors and the Securities and Exchange Commission to redress grievances. But on too many occasions, the Federal securities laws have become a tool for aggressive plaintiffs' lawyers to line their own pockets. The Dodd-Domenici Litigation Reform Bill is intended to address these problems comprehensively. SIA appreciates this effort and the Subcommittee's willingness to listen to our concerns.

Senator DODD. Is that an endorsement?

[Laughter.]

Mr. KASWELL. Not quite, Mr. Chairman.

[Laughter.]

Senator DODD. Just thought I'd ask. You never know.

Senator DOMENICI. It's an endorsement of the Domenici part I'm interested in.

Senator DODD. You can't have partial endorsements.

Mr. KASWELL. We appreciate when any Subcommittee listens to our concerns. Maybe I can leave it at that.

The Subcommittee is considering whether to enact legislation providing a private right of action for aiding and abetting a violation of Rule 10b–5. Our answer is an unequivocal no.

After Central Bank of Denver, investors who are defrauded still have many weapons against the bad apples. There is no gap that Congress must fill.

With regard to private remedies, investors who are harmed may claim the broad protections of the Securities Act of 1933, such as Section 11 or Section 12(2). The Securities and Exchange Act of 1934 provides broad remedies as well.

Rule 10b–5 still makes it illegal for any person to defraud, make a false statement, or engage in a fraudulent act in connection with the purchase or sale of a security.

Private rights of action always have been an important supplement to SEC enforcement action. Central Bank of Denver will not change materially the importance of those private rights. The private plaintiffs' bar has not been shy about bringing cases and there is little doubt that they will push the envelope of primary offenses under Rule 10b–5.

Even after Central Bank of Denver, the SEC remains well-armed in its battle against improper behavior. If wrongdoers lie, cheat, or steal, the SEC can and should bring an enforcement action against them under Rule 10b–5.

Other sections permit the Commission to take administrative action against a broker-dealer that aids and abets securities law violations including Rule 10b–5. The SEC has ample authority over broker-dealers. In addition to the Federal law, many States provide a broad range of remedies to investors. SIA believes that Congress should reject quick fixes for aiding and abetting.

As noted, we believe that nothing is broken, but we also note that the law of aiding and abetting was a morass and a cottage industry of lawyers had been trying to explain it. Aiding and abetting whatever the formulation cast a net of liability that was too broad and only helped an aggressive plaintiffs' bar draw in more defendants at the periphery. Restoring that mess will not provide meaningful investor protection and will not create more jobs except for lawyers.

We urge this Subcommittee to continue its comprehensive examination of these issues. We don't need more litigation and lawyers to champion wrongs that are more imaginary than real. In Utopia, Sir Thomas More wrote:

> They have no lawyers among them for they consider them as a sordid people whose profession it is to disguise matters.

There is no need for more lawsuits and lawyers. The Supreme Court's decision in Central Bank of Denver is both good law and good policy. The securities laws fully protect those who are injured.

Thank you, Mr. Chairman.

I appreciate the opportunity to present SIA's views. I'll be glad to answer any questions.

Senator DODD. Thank you very much.

Mr. Goldschmid.

STATEMENT OF HARVEY J. GOLDSCHMID, DWIGHT PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW

Mr. GOLDSCHMID. Thank you, Mr. Chairman.

The Association of the Bar, in the amicus brief you mentioned, concluded that the "preservation of the civil remedy" for persons damaged by aiding and abetting "is essential."

Although I want to emphasize today that I'm not speaking for the Association of the Bar, or Columbia, the words "essential to the

effectiveness of the Federal securities laws" were—and remain—not hyperbole.

The holding of the Supreme Court's 5–4 majority in the Central Bank of Denver case, if it is not legislatively overruled, will create either a serious undermining of the integrity of our securities markets, or years of confusion, unfairness, and unnecessary litigation while the word "indirectly" in Section 10(b) is read broadly enough to fill most of the gap that the Supreme Court's unfortunate holding has created.

The academic in me is tempted to spend time on a critique of the Central Bank of Denver case. The majority opinion is in fact rigid and unwise, but your invitation properly focused us not on the opinion but on the key policy issue for the future: "Whether imposing private civil liability on aiders and abettors is good policy."

My answer to your question is an emphatic yes.

I'll first address the policy issues and then present my recommendations.

Prior to the Supreme Court's decision in Central Bank of Denver, as you've heard before and know, aiding and abetting liability had been universally accepted by the lower Federal courts. The lower Federal courts have understood that aiding and abetting civil liability was required to impose an appropriate standard of diligence and care on professionals, such as attorneys and accountants, without whose assistance many financial frauds could not be perpetrated.

Investors in publicly traded securities often rely on professionals. These professionals, whether attorneys, accountants, appraisers, engineers, or geologists, act as "gatekeepers" who provide assurance to public investors of the financial integrity of their investments.

Recent scandals on Wall Street, in corporate disclosure documents, and in the savings and loan industry emphasize how important it is for these gatekeeping roles to be played vigorously.

In this regard, the Supreme Court's Central Bank of Denver holding provides precisely the wrong message. Without aiding and abetting civil liability, many of these "gatekeepers," on whose credibility buyers and sellers of securities depend, may be essentially immune from liability. But more important is the point Senator Gramm made earlier. They may be free, and conduct counts here, they may be free of the incremental spur to vigilance—the critical deterrent effect—that many need.

With my home town bias, I'm delighted to indicate and do so with great pride, that the Association of the Bar was willing to step up and assume appropriate responsibility.

In its amicus brief, at the end of its summary of argument, the Bar concluded: "As an organization of attorneys, the Association of the Bar is, of course, sensitive to the issue of lawyers' exposure to large damage claims. But it is also concerned about creating proper incentives for professionals and other persons involved in securities markets."

After a good deal of elaboration, that part of the brief concluded: "Public confidence in such professionals is essential to a sound securities market system. Enforcement of the securities laws against

transgressing professionals thus both serves the public and the best interest of the bar."

The Supreme Court's majority opinion in the Central Bank case left open two basic issues you've touched on today.

These could mitigate the harmfulness of the decision. First, whether the SEC will be able to continue to have the power to impose civil liability for aiding and abetting.

Here, although I think a court test is warranted, I have very little hope that the question will be answered affirmatively and I've elaborated on that in my statement.

Second, whether the phrase "directly or indirectly" in the text of 10(b) will be read broadly enough to cover most of those who have heretofore been charged with aiding and abetting.

I'm more optimistic about this, about the potential to reach indirectly professionals who have done wrongs, but it will, at best, take years of confusing and wasteful litigation before the word "indirectly" captures much of the ground that should never have been lost. And I elaborate on this point at some length in my statement.

My recommendations are as follows:

First, as is obvious, Congress should, as quickly as possible, legislatively overrule the Central Bank of Denver case and make aiding and abetting claims generally available to both the SEC and private plaintiffs.

Aiding and abetting should be defined in legislation in a traditional way as involving a primary violation, knowledge of or recklessness with respect to that primary violation, and substantial assistance.

Although I don't think it's a mandatory part of such legislation, I would suggest that Congress define what it means by "substantial assistance" I think that would be wise.

The basic idea, and I've given you various drafting suggestions in my testimony, is that substantial assistance requirements should not make vulnerable professionals whose connection with the transaction is remote or insignificant.

New legislation should also reaffirm what every lower court that has touched this issue has held, that recklessness is the culpability standard across the board under 10b for aiding and abetting and all other matters.

This issue was left open by the Supreme Court in its Hochfelder opinion in 1976 and is by far the most significant issue that has not been decisively resolved by the Supreme Court under the Federal securities laws.

A Supreme Court holding that only willful or intentional conduct violates 10(b) would have a potentially devastating effect: on director, officer, and professional behavior; on the soundness of our disclosure system; and on our securities markets. Directors, lawyers, accountants, and many others would have powerful legal incentives to simply ignore red flags suggesting fraud or egregious conduct.

This Subcommittee and Congress should perform a great service, perhaps the greatest service that can be performed in the business of our area, by confirming the applicability of a recklessness standard under Section 10(b).

Finally, new legislation could include balanced litigation reforms and other procedural and substantive provisions.

My basic qualification is that such reforms not significantly delay Congress from imposing or reimposing aiding and abetting civil liability and confirming the recklessness standard.

Thank you, Mr. Chairman.

Senator DODD. Thank you very much, Mr. Goldschmid.

Mr. Goldman.

STATEMENT OF EUGENE I. GOLDMAN, PARTNER, McDERMOTT, WILL & EMERY

Mr. GOLDMAN. Mr. Chairman, Members of the Subcommittee, I'd like to thank you for this opportunity to testify on the impact of the Supreme Court's decision in Central Bank and what, if any, potential legislative remedies might be appropriate in response to the decision.

Mr. Chairman, I view the Supreme Court decision in Central Bank as presenting the Congress with an opportunity, and the opportunity is to examine the whole issue of varying levels of liability for defendants in securities lawsuits. As the Supreme Court recognized, the rules for determining aiding and abetting liability have been unclear. They have exacted costs via vexatious litigation that disserve the goals of fair dealing and efficiency in the securities markets.

In this connection, I believe there is ample logic for the Congress to consider certain provisions of the proposed Private Securities Litigation Reform Act at the same time it considers whether legislation is necessary in response to the Central Bank case.

I'd like to briefly address the relevance of S. 1976 to the issue at hand as well as the following three issues.

First, does Central Bank apply to SEC actions which seek to impose aiding and abetting liability?

Second, is it essential that the SEC be expressly authorized at this time to bring actions for aiding and abetting violations?

Third, if Congress decides to add specific statutory language authorizing aiding and abetting claims in private suits, should it also express the prerequisites for imposing such liability and if so, what should the standard be?

I believe that the dissent's concern in Central Bank that the majority's decision may preclude the SEC for pursuing aiders and abettors in civil enforcement actions under Section 10(b) is well founded.

The majority relied primarily on the statutory text of 10(b) in holding that a private plaintiff may not maintain a cause of action for aiding and abetting under those provisions.

In other cases in which it has relied on the statutory text to determine the scope of 10(b), the Court has found no reason not to extend its holding both to cases in which the SEC is a plaintiff and in which a private party is the plaintiff.

Mr. Chairman, I think if you take a look at the Hochfelder case, where the Court held that a private plaintiff could not maintain an action for civil damages under 10(b) absent an allegation of scienter, that Court left open for another day whether that decision applied to the SEC. A few years later, in the Aaron case, the Court basically said, there's no difference in how you treat the scienter

requirement based on who the plaintiff is. They applied the standard exactly the same way.

If you look at the rationale in Central Bank, the way they focused in on the statutory text, it's my belief that if the SEC does determine to expend the resources to challenge it, they're going to lose.

After hearing the Chairman today, I think he has testified that within the arsenal of the SEC's enforcement powers, there are other provisions that can be used at this time.

The SEC has authority under Section 21(c) of the Exchange Act to obtain cease and desist orders. These orders can be obtained against persons who cause a securities law violation even if the persons are neither direct violators nor aiders and abettors, as long as they "should have known" that an act or omission would contribute to such violation. The SEC, by applying this negligent sounding standard, can stop violators in their tracks via the cease and desist proceeding and the airing of such charges.

In my view, Mr. Chairman, it has not been established that elimination of aiding and abetting liability would significantly diminish the effectiveness of Commission action protecting the investing public. From listening closely to the SEC Chairman today, I'm not sure he would disagree with me.

In the event that Congress determines to authorize aiding and abetting claims expressly, it should also consider establishing statutory prerequisites for imposing such liability. Such an express standard would obviously facilitate uniform judicial treatment of those who have not allegedly committed a deceptive act but only allegedly aided and abetted the violation.

I have been concerned for some time that the recklessness standard employed by different courts is arbitrary, borders too closely on concepts of negligence, jeopardizes participants in routine business transactions, and ignores the presence or absence of the duty of disclosure.

Mr. Chairman, in the event that Congress decides to establish a specific standard imposing liability, I'm sure there'll be no shortage of volunteers to draft a proposed standard requiring a showing of some actual knowledge of the primary violation, reliance and consideration whether the defendant owed a duty of disclosure to the plaintiff.

Mr. Chairman, the legislation which you and Senator Domenici introduced, the Private Securities Litigation Reform Act, contains certain provisions which are highly relevant to any consideration of whether the impact of Central Bank warrants a legislative response. As the Court in Central Bank recognized:

> Entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business investment, to abandon substantive defenses and to pay settlements in order to avoid the expense and risk of going to trial.

Mr. Chairman, that risk will remain very real if no regard is given to the degree of liability of each party or to a just proportion of the damages to be paid. I therefore recommend that the proportionate liability section of S. 1976 be factored into the equation when considering a legislative response to Central Bank. That way, the nature and conduct of each defendant and the causal connec-

tion between the conduct and plaintiff's damages will be recognized if aiding and abetting claims are permitted in the future.

In addition to Section 203 of the proposed bill, I would submit that Section 104 of the bill is also quite relevant to today's discussion because its purpose is to screen out, at the pleading stage, allegations that have no factual basis and compel greater clarity about the claims and issues in multiple defendant cases.

I thank the Chairman and Members of the Subcommittee for your consideration of my remarks.

Senator DODD. Thank you very much, Gene.

Let me commend all of you for excellent, excellent testimony.

Mr. Ruder, we're going to now hear from you, the former Chairman of the SEC, and it's a pleasure to welcome you back to this room in which you have more than a passing familiarity.

Welcome back.

STATEMENT OF DAVID S. RUDER, NORTHWESTERN UNIVERSITY SCHOOL OF LAW, FORMER CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Thank you, Senator Dodd.

Senator DODD. You are our cleanup hitter.

Mr. RUDER. I come here with a history of writing in this field since 1963 following the Rule 10b–5 field and having written what I modestly may say is the leading article on aiding and abetting.

I've also had some experience as Chairman of the SEC, as you've indicated, and I've observed the legislative process. And what I would like to speak about essentially is a matter of process.

Due to the broad language contained in Rule 10b–5, that Rule has provided the Federal courts with an opportunity to fashion the details of the law of securities fraud. And as a result, Rule 10b–5, with its broad language, has become the primary means by which injured persons and the SEC are able to recover from and otherwise punish those who have engaged in securities fraud.

Rule 10b–5 is the primary basis for doctrines dealing with insider trading, misrepresentations to purchasers and sellers of securities, market manipulation and broker-dealer obligations to the public.

In effect, by allowing Rule 10b–5 to be the chief remedy, Congress has allowed the Federal judiciary to develop a Federal law of securities fraud in a gradual manner. Although it's not easy to demonstrate Congressional legislative intent that the Federal courts should develop the rule, the overall results have, in my opinion, been salutary.

Many of the aiding and abetting lawsuits, as you've heard, are class actions based upon Rule 10b–5 on behalf of large numbers of injured purchasers and sellers of securities. Most typically, as you've also heard, the aiding and abetting defendants are accountants, lawyers, banks, and others whose role have been secondary.

The threat that these secondary defendants can be liable for all of the damage caused by the primary wrongdoers has had a dramatic effect upon the settlement negotiations in large class actions. These actions frequently have been settled by secondary defendants for significant sums because of the possibility that they will be required to pay the entire amount claimed.

In the absence of Congressional action, the holding of Central Bank of Denver case that aiding and abetting actions cannot be brought under Rule 10b–5 will help to alleviate some of the problems associated with the large damage claims.

In my opinion, those problems will not go away.

Plaintiffs in the large damage cases will now undoubtedly allege that accountants, lawyers, banks, and others now included as secondary defendants were primary participants in a scheme to defraud. The settlement bargaining process will continue and the secondary defendants, now to be called primary participants, will continue to be under enormous pressure to settle these cases.

I believe that this recognition that the holding in Central Bank of Denver can assist defendants in large damage claims, while it does not solve the problems, leaves Congress with a complicated set of possible solutions. Should it just do nothing? Should it merely overturn the Central Bank case? Should it overturn the Central Bank case and add guidance regarding development of the aiding and abetting doctrine? Or should it undertake a thorough review of the Federal law of securities fraud that some of the panelists seem to be suggesting?

My judgment is that what the Congress ought to do is merely to return the aiding and abetting cause of action under Section 10(b) and Rule 10b–5 to what it was before Central Bank was decided on the understanding that the aiding and abetting doctrine has been developed by courts in a gradual way and a way which is beneficial to the public and provides the kinds of remedies which are necessary.

Additionally, however, if Congress reverses the Central Bank of Denver case, and even if it does not, it should bear a responsibility for examining the economic effects of imposing unlimited liability in class actions upon a group of secondary defendants who are not likely to benefit in a manner commensurate with their misconduct.

The fees received by accountants, lawyers, and banks for their commercial services do not justify enormous dollar judgments against them in securities law class action cases.

I applaud the Committee for having introduced S. 1976 and have begun the examination process of how to deal with the problem. But in summary I think that if you wait until you have gotten all of the comments and all of the criticisms and all of the analysis that might be before you, you will not find yourself in an easy position of reversing Central Bank.

I would suggest a two-step process. First, reverse the Central Bank of Denver and then deal with the problems that are connected with the large class actions.

Thank you.

Senator DODD. Thank you very much.

Let me commend all of you for excellent and very helpful testimony as we look at these issues.

I'm going to ask the staff to limit each of us to 5 minutes so we can get to each other pretty quickly and not take up too much time.

I suspect a lot of the questions I have, Senator Gramm or Senator Domenici would also have. I may address the question to one or two of you, but any one of you who wants to comment, please feel free to do so.

Let me pick up, Mr. Ruder, on your last comment—one that's been reflected by a number of people, not the least of whom was our colleague from Ohio, Senator Metzenbaum, who has taken a similar position.

There seems to be some broad areas of doubt in the way the courts have applied the aiding and abetting liability statutes. We know of different standards that different courts have held.

I mentioned in my introductory remarks that we may potentially run right back into a Lampf situation. By just putting the language back in, without trying to deal with some of the very issues that have created this patchwork, turns it back over to the courts again. They can come back and decide any standard they may want to apply.

Different jurisdictions may come up with different definitions.

Aren't we getting right back into the same kettle of fish that we're trying to get out of, by merely inserting the language of aiding and abetting in the 10b statute, and giving the courts again an opportunity to do what we should have done years ago?

Mr. RUDER. Well, sir, it's been my opinion over the years that Congress should have provided a comprehensive law of securities fraud. But as I have observed the development of Rule 10b–5, including the aiding and abetting doctrine, I believe that this very sensitive area is one which can better be handled by a Federal judiciary which is able to deal with the subject matter as is occurs in a very shifting economic climate. And I think that if——

Senator DODD. On what basis can you say it? They've already indicated different opinions in the Federal judiciary.

Mr. RUDER. The Federal judiciary is not as split as some may like you to think. The central parts of the doctrine of aiding and abetting are very well established.

I think it would be possible for you to seize on the main doctrine and define it very simply as Mr. Goldschmid was suggesting, and do it in that way, but I think that if you go to trying to develop an entire law of securities fraud, as part of this, you will end up with an enormous project.

If I may make one other statement.

I think you can expect the Supreme Court, based upon the 5-person majority, to continue to whittle away at Rule 10b–5 and plaintiffs' remedies. And I think you will find yourself continually under pressure to deal in a remedial way with what the Court has done.

It seems to me that the appropriate way to deal with it is simply that, to deal with the Court's challenges to you, to adopt simple remedies to it, and not be bogged down in the effort to redraft the entire law of securities fraud.

Senator DODD. I'd just point out that in your own testimony, you state, prior to the Central Bank of Denver case, some areas of doubt in interpreting the aiding and abetting still existed. For instance, and you go down and cite very clearly. These are not——

Mr. RUDER. Exactly. But that's the way this common law of fraud has developed in our country. That's the way Rule 10b–5 has been being developed since the early 1940's.

Senator DODD. So you can have Federal courts of different jurisdictions arriving at completely different conclusions?

Mr. RUDER. Yes.

Senator DODD. Depending upon where you bring your cause of action, as a plaintiff, you can get entirely different results.

Mr. RUDER. If there are differences, then the Supreme Court has been the final arbiter in this matter. The law has grown that way.

Now if Congress wants to stop the Federal judiciary from providing it with a law of fraud in the way it has done, then I believe Congress is going to have to do a complete analysis of the law of fraud, and you'll be at that not for a year, not for 2 years, but for many, many years.

I think the system is working, it is not broken, and Congress can respond to the Court when it has, as in this case, laid down the gauntlet for you. It said, if you don't like what we're doing, change it. And I think you can do that in a discrete way whenever the Court says, we disagree, whenever you disagree with the Court.

Senator DODD. Let me ask you, Mr. Goldman, to respond to that same question.

Mr. GOLDSCHMID. Well, we're on much the same——

Senator DODD. Mr. Goldschmid, I want to ask Mr. Goldman. Maybe we should have separated you two.

Mr. GOLDSCHMID. Oh.

Senator DODD. Mr. Goldman.

Mr. GOLDMAN. Mr. Chairman, not only are many circuits applying the same standard to varying facts, and the outcome, as you say, depends on accident or where the case was filed, but you have a situation where the so-called leading circuit on securities law, the second circuit, has a different standard all by itself from most of the other circuits.

As made clear in the Ross v. Bolton case, the Second Circuit said plaintiff must always prove conscious intent to defraud, which is a step above the recklessness standard that may of the other circuits are employing.

So that's why I think it's incumbent that, if you're going to move ahead and remedy Central Bank, if Congress thinks a remedy is necessary, that you spell out in full what the prerequisites are, because you have a lot of courts applying the same standard differently based on different facts, and you have some leading circuits, like the second circuit, having their own standard.

And I think it is somewhat unfair to businesses not to know how to adjust their conduct because of where the lawsuit might be filed.

Senator DODD. Let me come back to you, Mr. Griffin. You brought this very pretty map here with you. It may be one of the few times in history where Connecticut and Texas are considered together in this.

[Laughter.]

I suspect it has something to do with the aggressiveness of our local bars, by the way, in these particular areas.

It seems to me that if we leave this map up, it will make the case. I mean, that's a mess.

Mr. GRIFFIN. It is a mess.

Senator DODD. Where's the fairness in this? You're lucky if you live in one of these white blocked out States or a red State. It seems to me that our country is trying to develop simple standards so that everyone can know what the rules of the road are going to be, but it becomes difficult when you're dealing with multinational

and large corporations that have divisions all over the country. Just bring out your map—I can tell you where to file litigation.

Mr. GRIFFIN. Right.

Senator DODD. That's not a very healthy way to proceed.

Mr. GRIFFIN. And as you know, some of the borders of our States are drawn——

Senator GRAMM. And that's how people decide where to file.

Senator DODD. Sure they do.

Mr. GRIFFIN. As you know, some of the borders of our States are drawn along riparian boundaries and if you live across the river, you have a different remedy. And we don't feel that that's——

Senator DODD. This is not the 18th Century we're talking about. We're talking now about the 21st Century and global marketplaces.

Mr. GRIFFIN. Right. And we feel also that the question has been raised whether or not there will be a migration of the litigation from the Federal courts to the State courts, depending upon where you can bring your action.

Also, there's some question as to how the Federal district courts are going to be dealing in the wake of Central Bank with some of these State laws with respect to pending State claims under Blue Sky Law of which there are quite a few.

Senator DODD. I know this is State law that we're talking about.

Mr. GRIFFIN. Yes.

Senator DODD. We're talking about Federal law, and the map would look a little bit different. There wouldn't be quite as many different colors but there would still be different applications of the aiding and abetting statute. I would think that while certainly States like to preserve their prerogatives, that it would be in everyone's interest. In fact, hasn't your organization even suggested model statutes for the whole country?

Mr. GRIFFIN. Yes. Of course, there's a uniform act. Unfortunately, the uniform act is being interpreted differently very similar to the 10b–5.

Senator DODD. You would agree that we ought to try and have——

Mr. GRIFFIN. Yes. I agree. I think ambiguous language in any statute is really the delight of a trial lawyer. I think, to the extent that we can be precise and specific in what we're talking about, that would be good.

But again, I would caution and advise the Committee not to move forward on the broader issues that you've been invited to address here pertaining to litigation reform. I think the need is immediate to deal with Central Bank, and then we'll have time to approach these——

Senator DODD. I feel strongly about my own bill, along with Senator Domenici, and I appreciate your comments and I appreciate the comments of those who suggested that we ought to go further.

I, for one, believe we're dealing with a similar subject matter and I'm interested in these questions of how do you fix this, should it be fixed, does it need to be fixed, how important is it that we fix it immediately if it needs to be fixed.

Let me turn to my colleague.

Senator GRAMM. Mr. Chairman, there are several ways you can look at this map of the United States of America. One way you can

look at it is our ability to vote with our feet. The problem is if you color the whole country red, you're looking at voting with your feet by taking your money to markets in Japan or London, markets in Germany and maybe someday a market in Mexico City.

If States want to promote litigation and in the process burden their businesses, they pay for it. And as a result, markets work, people move, capital flows, and ultimately the State is forced to come into line with reason and responsibility.

The problem is, when we impose regulatory burdens nationally, we lose the ability to vote with our feet, except by moving across national boundaries. It doesn't make me happy to see investment go from my State to New Mexico, but on the other hand, if Texas is going to commit legal suicide, I'd rather that the business go to New Mexico than go to another country.

I want to make one more point, because I don't want anybody to leave here with any hope in their heart. There is no chance in this world that we are simply going to put these two words back in this law. That's not going to happen. We're going to do one of two things, it seems to me.

One, we are going to do nothing, or we are going to have responsible, broader reform. If I believe this Committee could write the bill, I'd be very much in favor of legislative action. Quite frankly, I think this Subcommittee, with the influence on the Full Committee, could write a good bill. A bill that could deal with the problems while limiting liability to the proportionate degree to which someone is culpable for doing wrong or imposing damage. I think we could come up with reasonable standards about what somebody should be liable for in terms of behavior. The problem is, I have every confidence, that the House of Representatives will mess this up.

[Laughter.]

Senator GRAMM. So my inclination in that scenario is to do nothing. But the idea that we're just going to simply put these two words back in the law, is totally out of the question. It's never going to happen.

Now I'd like to ask some questions.

If we were going to legislate and try to deal with the whole problem of legal liability in terms of its impact on the market, and therefore behavior and wealth creation and job creation, what is your view? I'd like to try to get close to a yes or no if I could, and I know it's hard. On the proportionate liability proposal by the Chairman and Senator Domenici, I'd like to get your views, in maybe just one or two sentences.

I'd like a yes or no, and then one or two sentences, do you support that. And Mr. Langevoort, let me start with you.

Mr. LANGEVOORT. Yes. As written in the bill, which distinguishes between primary and secondary liability with respect to secondary participants.

Senator GRAMM. You support the entire bill?

Mr. LANGEVOORT. Yes.

Senator GRAMM. Mr. Griffin.

Mr. GRIFFIN. NASAA opposes professional liability.

Senator GRAMM. What do you think as a representative from your State?

Mr. GRIFFIN. What do I think as a State?

Senator GRAMM. You are here on behalf of NASAA. What are your views as securities regulator for Utah?

Mr. GRIFFIN. I have to admit that the Utah legislature, I believe, has subscribed to proportionate liability.

In terms of recovery, I've given testimony before this Committee before that the gatekeeper role of the individuals who are involved in this activity is sufficiently high and of sufficient importance to require a higher standard of liability if something goes wrong. I think the allocation of liability ought to be directly correlative to the harm caused by the entire fraud.

Senator GRAMM. Proportioned based on who actually caused the problem and who happened to be just standing there looking out the window?

Mr. GRIFFIN. I'm not sure I understand the question.

Senator GRAMM. In other words, what their bill says, that, if harm has been caused, people should pay for it, but we want them to pay in proportion to their action in doing the harm.

Mr. GRIFFIN. What is not understood and what has not been dealt with is that you are allocating losses when you do that. You are placing losses on the part of somebody, and NASAA subscribes to the theory that the losses ought to be placed on those who have some responsibility for the harm.

You know, there's a great debate taking place on the Hill with respect to how we look at crime in this country. And I would dare say to Members of Congress that most elderly people that I know would rather get their purse snatched and knocked to the pavement than lose $10,000 worth of their income. And on top of that, to have the insult of not being able to redress that sufficiently to go after those who are principally responsible in any way that they can, is an insult.

So that's our point of view, and I have to temper my remarks by saying I've worked 9 years in securities regulation and that's an important and valid point of view. I realize that there are other competing concerns with respect to capital formation.

But also there's been some talk about the ripple effect of this opinion. Well, when you drop a rock in a pond, the ripples go out in all directions. And you need to consider how investors are being rippled right now by the decision in Central Bank, those people that have actually lost money, and their harm is real. And to my knowledge, the studies have not been done yet to indicate that there is significant harm to the current system of capital formation by way of the current system of litigation.

Senator GRAMM. Let me just run quickly down the panel on the same question. The Dodd-Domenici provision in a comprehensive reform, should it be part of a bill?

Mr. KASWELL. SIA has testified that it favors the concept of proportionate liability, and I'm not sure we're ready to embrace the specifics of that formulation in the bill.

Senator GRAMM. Mr. Ruder.

Mr. RUDER. I believe there's a problem and that proportionate liability is one way to solve it. I'm not sure it's going to solve the problem because the bargaining process, the settlement negotiations will be the chief problem.

I must say that one of the portions of that legislation that intrigues me is the apparent benefit analysis and a monetary cap on the amount of recovery which might be given and might be charged against any particular alleged aider and abettor.

That makes some sense to me. That is, the accountants and the lawyers and others who are providing assistance may not be the ones who should be required to pay very, very large amounts which are incurred by the people who are doing the actual wrongdoing.

Mr. GOLDSCHMID. I haven't worked through the details of the bill, but proportionate liability is certainly worth considering with two basic qualifications.

One, we've got to think about the bankruptcy situation, where there's no one left.

Senator DODD. We cover that in the bill.

Mr. GOLDSCHMID. Two, there are some very difficult procedural and settlement issues out there that David Ruder was just referring to. I've spent much of my practice time consulting with defense counsel, and the last thing you want to see in a major securities litigation is the defendants shooting at each other.

There are procedural issues to be worked out, where defendants won't be forced into a "war" with each other, and then settlement aspects have to be worked through; and finally, I'd have to work my way carefully through the bill. But it's certainly worth considering.

Senator GRAMM. Mr. Goldman.

Mr. GOLDMAN. If you have a situation for aiding and abetting alleged, that means that there's someone who actually engaged in deceptive practice and someone who aided and abetted someone else's violation.

I think in a sense, you have some difference when it comes time to pay up based on such a stark difference. So it's a concept I would say is definitely worth considering.

Senator GRAMM. Let me ask one more question.

Before I do, let me say, Mr. Chairman, this is an excellent panel. It's an excellent panel because it presents us with a lot of different views, and I think everyone has done a good job in expressing his view.

Obviously, if you're worried about the cost of litigation on capital formation, on job growth and competitiveness in the country, you will have one view. But you can also take the view that if you might give somebody the ability to recover a nickel in damages, even if it imposes a billion dollar cost on the economy, it's worth it. That's not a view that I think most people would take, however.

One way that other systems have dealt with this problem of trying to get a balance in the court, so that people with real claims who have really been damaged and who have a case will have incentives to file them, while people who are looking for a deep pocket or somebody to settle with them out of court won't, is the lose or pay system. It's interesting to me, for example, that we see a big push to imitate the medical system in Great Britain, which doesn't work, but we see the same effort to imitate the legal system, which probably works at least in this area better than any other in the world.

Let me ask, in terms of this comprehensive reform that we would be looking at, what you think about a lose or pay provision, say in these types of transactions?

Mr. LANGEVOORT. I assume you mean loser pays the attorneys' fees and other costs associated?

Senator GRAMM. Yes.

Mr. LANGEVOORT. I am not in favor of that as the way of handling the problem that I think you and I agree exists. I think when you have as claimants small investors around the country, they cannot afford to pay the legal fees.

And if the message to them was, if you think you have a 50 percent chance of winning, a 50 percent chance of losing, and if you lose, you pay the defendant's legal fees, I don't think that suit gets brought.

I think there are better ways of dealing with the incentives to file meritless actions.

Senator GRAMM. If you would do a little two-pager on that and send it to me, I'd read it.

Mr. LANGEVOORT. I'd be happy to.

Mr. GRIFFIN. I agree with Mr. Langevoort that the chilling effect is not worth it. I really feel like the individuals who are bringing these suits are not well-heeled and sometimes the corporations are, and I have heard the arguments from various flanks that there are incentives on all sides of these lawsuits to draw things out to make vexatious claims and counterclaims on all sides, and that costs real money.

The ability of a defense counsel, for example, to ratchet up that price tag, would be a significant chilling effect, not only a barrier to the courtroom but also a significant hammer to force an unjust settlement.

Mr. KASWELL. Our members have not favored going to a loser pays formulation. We think that there are serious problems with the litigation system but that may not necessarily be the best way to approach it.

Mr. RUDER. Despite the fact that the Securities Act of 1933 tends to provide that remedy, I do not favor it in this legislation.

Mr. GOLDSCHMID. I think the chilling effect is much too great for any possible gain. I'd like to emphasize, stepping back, that a great success of our system has been the capital formation and the securities processes. That is helped meaningfully by the ability of the SEC and the ability of private plaintiffs to bring litigation. There is great value in the incentives and deterrents it creates.

To understand why this system works, you must understand the securities laws and the effect they have on real people.

Mr. GOLDMAN. Lose or pay, I believe, would result in good faith claims not being filed, claims which have merit not being filed. I think to the extent there are baseless claims, frivolous claims, the court should sanction not only the party but opposing counsel under Rule 11.

There are some Federal Rules of Civil Procedure that can take care of a lot of the abuse.

Senator GRAMM. Thank you, Mr. Chairman.

Senator DODD. Yes. I'd point out that in the bill, I'm opposed to the so-called British rule for the reasons that our panel has stated.

There is, under existing law, as Chairman Ruder has pointed out, the ability for a court to impose attorneys' fees, but there's a standard there that must be met. It's rarely done but it is there, and it can be used.

We have put some speed bumps in our legislation such as requiring an allegation of financial loss before a case could be certified, not brought, but certified. And also requiring greater specificity in the complaint so that you at least have the sense that someone other than a computer might have written this complaint.

We had the situation the other day where—I don't know if I'd told you this or not, Pete—but someone sent to me a complaint that they received in this area where the computer had screwed up so that the first part of the complaint had this particular plaintiff named, and then it had a totally different company on the second half. No one even bothered to read the complaint because it was just being generated by a computer. We're trying to get away from that.

We think that with some of the speed bumps here that I've described in the litigation, and also, to protect people with net assets below a certain level so that the joint and several would still apply where they would lose absolutely everything is a way to hedge against that.

We must make sure that where there has been willful conduct that the joint and several would still apply, so as to send that clear and valuable signal that this is not to be construed as a big break for those people who engage in fraudulent or illegal activities.

Your comments are interesting and very, very helpful.

Let me turn to my colleague from New Mexico, if he has any questions.

Senator DOMENICI. Well I want to thank you for calling the hearing, and thanks to all of you for coming.

Senator Gramm indicated he was not a lawyer. He's done very well not being a lawyer and getting to the root of the problem.

I am a lawyer, so you will know, for the lawyers there at the table, I still have an abiding respect for the profession. But with the passage of time, it's getting dimmer and dimmer and dimmer and dimmer. And so you'll also know, that I thought enough of it that I didn't say to my children, you cannot be lawyers, three-eights of my children are lawyers, three out of eight. I've signed an agreement with the other five.

[Laughter.]

Senator DOMENICI. And it's very simple.

Senator DODD. Drafted by the other three.

Senator DOMENICI. They argued for a hell of a long time. But anyway, the agreement says the five are going to have to go out and earn a living so the lawyers will have business.

[Laughter.]

Senator DOMENICI. In other words, they'll have to be productive. Frankly, if that sounds cynical, it is.

Mr. Ruder, I just want to tell you, it may be that we could have solved this no other way but I cannot imagine, other than an admission that we don't know how to write a law, or it's too complicated, or it is too political. However, I cannot imagine a worse

situation than to turn over the liability to the courts of America, Federal or otherwise, and say, "make it up as you go along."

And then have a great professor go back and look at it, and say, it sounds pretty reasonable, they've been doing a pretty good job.

From my standpoint, what's missing in that is we don't know how many hundreds and hundreds of defendants that probably never should have been sued and never paid did, because we'll find out way further down the line that the evolution of this court created private action wasn't quite right, and we've seen the most perfect example of it right now.

I mean, this evolution through the mighty rectitude of our courts and their great wisdom. We witnessed the Supreme Court come along now and say, "hey, the lower courts have been wrong regarding aiding and abetting all this time." In fact, I wonder how many hundreds of millions of dollars that defendants might not have been legally liable for were paid nonetheless in settlements.

Let me finish my thoughts for you. Just a moment.

Senator DODD. Let me add, Pete, though, too.

Senator DOMENICI. Sure.

Senator DODD. There are plaintiffs that may have been significantly disadvantaged. I think it's important.

Senator DOMENICI. Absolutely. Because it's vague, it's not the way to base the securities law of this Nation and certainly in today's world, it's not the way to do it.

We have small high tech companies. Let me tell you, you all keep saying that there's 50 or 60 or 100 lawsuits on this. I mean, I don't know where the small corporations, where they're coming from, but I have a whole file of them thanking me for introducing this legislation, saying that it's a threat, that they don't know what the law is, that they're having difficulty getting board members, that the deep pocket concept is scaring people off.

They're settling lawsuits. One of them tells me they settle them because the risk of litigation is too big. In fact, one of them said these law suits are so prevalent that every pro forma that I prepare, I plug in anywhere from $10 to $15 million that we're just going to pay some lawyers for one of these suits. That's even before a company ever goes public. It is an amount equal to the capital need to develop a new product line. I don't think this is the way we ought to do it, OK, so that's on a broader subject.

But what I would like to know, perhaps we'll start here with just a question. Do you think that the Securities and Exchange Commission's ability to enforce the law against those who perpetrate fraud has been damaged by this interpretation?

Mr. LANGEVOORT. It's been damaged, but perhaps not by as much as some alarmists might think. This Congress decided in 1990 that civil penalties against those associated with fraud are an important deterrent. That's been lost and that is a loss.

Senator DOMENICI. I believe there's an argument for doing something, and I intend to agree with Senator Gramm, we ought to do more than just fix this. But I think if the Securities and Exchange Commission, as a public entity, has lost some significant authority, then we ought to talk about that on a short-term basis.

Frankly, I have no concern that the securities purchasers in the United States, those people buying stocks, are going to get hurt

more by fraudulent people with the abolition of these two words—aiding and abetting—by the courts, because I think lawyers are going to find ways to file those suits anyway.

I know you make a distinction between primary and secondary violations. After Bank of Denver lawyers won't. They're going to say well, aiding and abetting is out but we will just find another way. They're going to change those complaints in the computers.

Mark my words, if you could get into one of the select big law firms that file these 106 class actions, there's about a 100, and just check in the next month and see what's happened, I would bet the only thing that's going to happen is they're going to change some language in their computer that punches out these lawsuits to get around this.

They're still going to sue the accountants, they're going to sue the bank, and they're going to say they are primarily liable. Perhaps some judges will dismiss the case early, but they'll stay in long enough to settle for about $20 million on every kind of issue that's around. Now I note some of you nodding affirmation. Is that a way to run the securities enforcement of this country?

To me, if we weren't so powerful and strong, and the market wasn't so big and powerful, this abusive approach just wouldn't work. But capital markets are so big and so vibrant we don't readily feel the harm, but is there in the form of a higher cost in capital. If we waste just $150 or $250 million a year and just rip that off; we can commission academic research to conclude that the capital markets and our securities litigation system are working pretty well.

And I think you all do great work in that regard, and I respect you greatly.

Perhaps you could tell me, Mr. Ruder, why do you really think we ought to address Central Bank's decision now other than because of its possible adverse implications for the Securities and Exchange Commission? Who's going to get hurt? And do you really believe that there's going to be more fraud if we don't recreate aiding and abetting liability back into the system so that lawyers can sue on it as a legal theory?

So people will really know if you're aiders and abettors, even without knowledge, are they going to stop doing that.

Mr. RUDER. I believe that those who have said that the difference is marginal are correct.

I'm reminded of a lawyer that used to work for the Securities and Exchange Commission named Stanley Sporkin and after the Hochfelder case in which the court said, in order to have a securities violation, there must be scienter and Stanley's answer was, if they want scienter, we'll give them scienter.

[Laughter.]

Senator DOMENICI. That sounds like Stanley.

Mr. RUDER. I think you could say the same thing in this situation. If they want primary participants, we'll give them primary participants.

My guess is that the plaintiff's bar will immediately charge everyone as primary participants and we'll still get into the settlement negotiations as we have. And one of my primary goals here

is to urge you to try to deal with this large class action settlement problem. But I would like to raise one other response to you, sir.

Senator DOMENICI. Please.

Mr. RUDER. And it is personal. But from the period 1970 to 1980, I served as consultant to the American Law Institute Federal Securities Code Project. I served as a consultant to Part XVI which was entitled "Fraud, Misrepresentation, and Manipulation," and to Part XVII, which was entitled "Civil Liability." We produced some 60 or 70 pages of legislation with comment and asked Congress to adopt it. Congress did not.

And if you do want to go back and look at this field, I suggest that you go back to the American Law Institute's Federal Securities Code Project.

My experience will tell me you'll never adopt it. And the reason that I say is you need to have a series of quick fixes is because of my despair unfortunately with the legislative process.

Senator DODD. We'll take a look at that. Why don't you send us a copy of that if we don't have it.

Senator DOMENICI. Yes. And if this problem with reference to the civil law, plaintiff/defendant law, not the Securities and Exchange Commission, if the problem's only a marginal one, what's the hurry to fix that up? My definition of marginal is that it's not very important, not very urgent. Maybe that's wrong?

Mr. GOLDSCHMID. Senator, I do think that's wrong. I think——

Senator DOMENICI. I was asking him because he used the word.

Mr. RUDER. I think the word, marginal, is an important word, but I tend to think that the therapeutic value of saying to people, you may not participate, you may not help other people to commit fraud, is very important.

My problem is that, as with everything, I want to get at the bad people and I'd like to protect the good ones. And the problem that you're facing is how to get at the people who are consciously aiding people to commit fraud and still avoid unnecessary lawsuits against people who are really doing just their ordinary jobs in good faith.

I think if you do touch this field at all, you'll really want to look at the mental state intent part of this to deal with the question of what kind of definition you want to put in to a definition of aiding and abetting liability. Whether you want to say knowing or reckless or actual intent, I think you should use words which would suggest a very high standard of culpability.

Senator DOMENICI. Mr. Goldschmid, excuse me for interrupting you.

Mr. GOLDSCHMID. No, I'm sorry for interrupting.

The word "indirect" is going to create just the problem that makes you suffer as a lawyer. It's going to create chaos out there. It's going to fall from every plaintiff's complaint, and then we're going to litigate it. And some who ought to be found liable are going to get away if the lower courts incorrectly use that word; some are going to be found liable in situations where we wouldn't want it. It will create a morass out there, and that's where we're headed because of where the Supreme Court left us, unless you do something within a relatively short term.

Senator DOMENICI. You don't think both plaintiffs and defendants think we're in some kind of a morass now?

Mr. GOLDSCHMID. It can get worse. We want it to get better.

I do think you have a right to say we ought to be more specific in our definition of aiding and abetting. We ought to take the common ground, which I think is broader than has been described, and then add to it some.

Although keep in mind this is not an area to do a tax code. This is an area where you want enough specificity to give warning and notice and be fair, but not try to do so much that you freeze the law, or make the law rigid in a foolish way.

Senator DOMENICI. Could I ask the Professor from Vanderbilt?

The Supreme Court mentioned the particular problems that aiding and abetting liability poses for new and small businesses. You might have quoted it. I think the Chairman did.

I know that the high-tech industry has been especially hard hit by meritless lawsuits, at least in their opinion, and I think some outside reviews have indicated that's true. What refinements of aiding and abetting liability would best protect these businesses under these circumstances?

Mr. LANGEVOORT. I think there are two refinements, and I'm not sure they are both definitional.

One, which I think echoes something you've heard from other members of the panel, is that the concept of recklessness is a dangerous one when you're talking about the liability of secondary participants, and some attention to defining the right state of mind is important.

The other mechanism, I think, has to go beyond aiding and abetting. It is to have some way of getting rid of meritless or frivolous claims, especially against collateral participants.

My own suggestion is that you have, in any securities class action, an evidentiary hearing right after filing, where the court looks at the merits of the action and determines whether it's worth going to discovery. If you can weed out the meritless actions, I think the impact on small business diminishes.

Senator DOMENICI. Mr. Ruder, one last question.

You indicated in your University of Pennsylvania Law Review article, that securities and fraud litigation increased dramatically starting in 1962.

Mr. RUDER. Correct.

Senator DOMENICI. And you said that most cases involving attacks on multiple defendants have included demands for extremely large amounts of damages.

Mr. RUDER. Still true.

Senator DOMENICI. Has this continued? And what do you attribute this to?

Mr. RUDER. I attribute it to the court's abolition of the doctrine of privity in Rule 10b–5 cases. What the courts have done is to say that actions may be brought by plaintiffs against individuals who have made misstatements to the public even though the person charged with the liability has neither purchased nor sold a security. That together with the changes in the rules of civil procedure to permit the so-called opt-out class actions have permitted the aggregation of claims.

It is something that Congress might want to look at, but it certainly exists in this day and age. It's the centerpiece for the class action claims against corporations who have made misstatements in the market.

Senator DOMENICI. Mr. Chairman, perhaps at this late hour, I would just submit about 5 or 6 questions and spread them across the witnesses as they speak to the witnesses. How long do we have for answers? Two weeks?

Senator DODD. Well, as soon as we can.

Let me ask you for a brief response, as Senator Gramm did.

You are all familiar with this decision and part of the question I think that Senator Domenici was asking was whether or not we, at the very least, ought to be doing something to guarantee that the SEC enforcement for this area is not diminished. Obviously, that's the subject of some debate.

In your assessment, or the assessment of your legal counsels, or people whose legal judgment you appreciate, what is your conclusion. Does the decision by the Supreme Court limit the ability of the SEC to bring enforcement actions under the aiding and abetting language?

Mr. LANGEVOORT. I would use the phrase that it is highly likely that it takes that power away from the SEC.

Senator DODD. Highly likely?

Mr. LANGEVOORT. Highly likely that it takes the power away.

Senator DODD. It does take it away?

Mr. LANGEVOORT. Yes.

Mr. GRIFFIN. Yes.

Mr. KASWELL. It certainly undermines it. I think, though, there are many other remedies the SEC has so the effect of that may be somewhat diminished.

Mr. RUDER. Yes. It not only takes that away but other theories, including respondent superior and conspiracy, and there are other things in this Court's opinion which I believe will further diminish the SEC's powers.

Mr. GOLDSCHMID. A principled application of the Court's rationale takes it away from the SEC, indeed, I see little hope without a change in one Supreme Court vote.

Senator DODD. That may happen this afternoon.

Mr. GOLDMAN. No, it's the wrong vote.

[Laughter.]

Since the decision was based on the text of the statute as opposed to who was the plaintiff, the answer is yes.

Senator DODD. Well, I think that's very interesting and very helpful to get that diversity of opinion. It's important for us to know that.

We've kept you a long time and there will be, I'm sure, some additional questions that Members may want to submit. If you could please get responses back as soon as possible. This issue require some attention sooner rather than later.

Mr. GOLDMAN. As you mentioned earlier, the Chairman will have no shortage of volunteers in terms of drafting suggested language at the Subcommittee's pleasure.

Senator DODD. Well, I mentioned that. I appreciate your bringing that up. I would invite all of you here to submit, if you have some

ideas on language, as it pertains both to the acts of private litigation as well as SEC enforcement in this area. Although this is not a hearing on Senator Domenici's and my bill, we invite as well your comments and ideas on that, and ask you to look at.

I found your responses on the proportional questions that were addressed, very, very interesting, and I'd like to hear some additional ideas and thoughts you have on that, as well. I appreciate your raising that issue.

Senator DOMENICI. Mr. Chairman, I wasn't here but I'm told that our good friend, Senator Metzenbaum, alluded to how much the RTC might lose because of the abolition of the aiding and abetting language of liability.

I would ask the Chairman to seek a more authentic answer from the staff and put it in the record, but we did call somebody over there and it didn't seem quite right to me that very much of the RTC's activities in taking care of these banks would be aiding and abetting fraud cases. And the answer was that that settlement was mostly not pertaining at all to 10b–5, aiding and abetting. Most of it was State law claims and others, and I think we ought to clarify that.

Senator DODD. Did you want to comment on that, Mr. Goldman?

Mr. GOLDMAN. I don't think you will find 10b–5 used extensively by the RTC in those cases, since the RTC was basically sitting in the shoes of the former S&L entity, almost like a receivership or trusteeship.

You have State law and you also have Federal banking law, savings and loan law, so I don't see where 10b–5 was a major factor in those suits. Now in the private litigation in the private suits, in the Lincoln and the other suits, it was a factor.

Senator DOMENICI. It just seems to me that one of the reasons we were being urged to move quickly is maybe we have that RTC losing a bunch of money, and I think we ought to clear the record up on that.

Senator DODD. I appreciate that point very much.

We thank you all again.

We thank the staff on the minority and majority side for their work.

This Committee will stand adjourned.

[Whereupon, at 5:25 p.m., the Committee was adjourned, subject to call of the Chair.]

[Prepared statements, response to written questions, and additional material for the record follow:]

PREPARED STATEMENT OF ARTHUR LEVITT

CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE *CENTRAL BANK OF DENVER* DECISION

Chairman Dodd and Members of the Subcommittee: I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding the Supreme Court's decision in *Central Bank of Denver. N.A.* v. *First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230 (U.S. April 19, 1994).

In *Central Bank of Denver,* the Supreme Court held that the Federal securities laws do not provide investors with a private right of action against persons who aid and abet violations of Exchange Act Section 10(b) and Rule 10b–5 thereunder. The decision means that private investors may no longer be able to recover from persons who substantially assist in a securities fraud, even if such persons act knowingly or with a high degree of recklessness. The decision also creates uncertainty as to the Commission's ability to use the aiding and abetting theory of liability where it is not expressly provided by statute. The Commission therefore believes it is desirable, in order to ensure the effective operation of the Federal securities laws, that Congress enact legislation addressing the *Central Bank of Denver* decision.

The *Central Bank of Denver* decision did not specifically deal with Commission enforcement actions. It can be argued that the Court did not intend to restrict the Commission's ability to pursue aiders and abettors, and the Commission may choose to pursue these arguments in one or more selected cases. Because other enforcement options are available, however, the Commission does not believe that devoting substantial resources to litigate the question whether the *Central Bank of Denver* decision applies to Commission enforcement actions would serve the public interest. To do so would simply generate uncertainty, and the diversion of resources would reduce the effectiveness of the Commission's overall enforcement program. The Commission has therefore determined that it will generally refrain, at this time, from asserting aiding and abetting theories of liability where the statute does not expressly provide for such claims.

The Commission's preliminary assessment is that its enforcement program can continue to operate effectively under these circumstances. The Commission believes that some enforcement remedy will continue to be available against most defendants that the Commission previously would have pursued on an aiding and abetting theory. It is likely, however, that after *Central Bank of Denver* the Commission will bring more cases under its administrative authority, which does not provide for civil money penalties as to non-regulated entities. The Commission will also be confronted with cases in which it must sue in Federal district court, to obtain penalties and other appropriate relief against principal violators, and also proceed administratively against secondary participants. Legislation expressly providing that the Commission can seek injunctions and other relief against aiders and abettors is necessary to preserve fully the strength and flexibility that Congress intended to provide when it enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

Legislation to restore aiding and abetting liability in private actions is also necessary in order to preserve the benefits of private actions as a source of deterrence and a vehicle for compensating private investors.[1] The Commission recognizes that this Subcommittee is considering other policy issues that involve private litigation under the Federal securities laws. Efforts to improve our litigation system are important, and the Commission will continue to support measures that are carefully crafted to achieve this goal.[2] The *Central Bank of Denver* decision deserves your particular attention, however, because it has fundamentally curtailed well-established and vital investor rights.

As I stated in a speech earlier this year, our private litigation system will not serve its intended purposes if it "fails to distinguish between strong cases and weak cases."[3] The *Central Bank of Denver* decision illustrates why it is important to ad-

[1] Commissioner Beese agrees that legislation may be needed to preserve the benefits of private actions as a source of deterrence. However, he believes that this legislation should be specifically conditioned on significant legislative action to correct abuses in the system that facilitate or even encourage vexatious litigation. *See* J. Carter Beese, Jr., *Stock Option Accounting and Securities Litigation Reform,* Remarks Before the Association of Publicly Traded Companies (Nov. 15, 1993); *Remarks Before the American Society of Corporate Secretaries* (Feb. 16, 1994).

[2] *See Concerning Private Litigation Under the Federal Securities Laws: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs,* 103d Cong., 1st Sess. 111–21 (1993) (testimony of William R. McLucas, Director of the Commission's Division of Enforcement).

[3] *See* Arthur Levitt, *Private Litigation Under the Federal Securities Laws,* Remarks at the Securities Regulation Institute (Jan. 26, 1994).

dress abuses in the system through legislation, rather than to rely solely on the courts. Judicial decisions of this type are blunt instruments reaching results that affect broad categories of cases without regard to their merits. They are not a substitute for legislation that is carefully tailored to ensure that it does not affect meritorious cases.

I. The Central Bank of Denver Decision

Prior to the Supreme Court's recent decision, the Federal courts of appeals had unanimously held that a private right of action existed against persons who aid and abet violations of Section 10(b) and Rule 10b–5.[4] In reversing this well-established body of law, the Court distinguished between cases regarding "the scope of conduct prohibited by § 10(b)," which are governed strictly by "the text of the statute," and cases regarding "the elements of the 10b–5 private liability scheme."[5] It characterized the case as one regarding the scope of the prohibition, and found that "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation."[6]

In addition to the textual analysis, the Court also discussed and rejected other arguments in support of a broader reading of the statutory language. With respect to the issue of congressional intent, the Court reviewed the express private causes of action in the Exchange Act and observed that none creates private liability for aiding and abetting. From this, the Court inferred that Congress would not have intended to create such liability under Section 10(b).[7] The Court also declined to infer a congressional intent to establish private aiding and abetting liability from the status, at the time the Exchange Act was enacted, of aiding and abetting liability in criminal, tort, and securities law.[8]

The Court then considered the argument that Congress had repeatedly amended the Federal securities laws without disturbing any of the aiding and abetting precedents established over the past 30 years. While the Court acknowledged that its prior decisions have not been consistent in rejecting arguments based on subsequent legislative history, it stated that such arguments "deserve little weight in the interpretive process."[9]

With respect to the argument that private aiding and abetting actions are necessary to effectuate the remedial purposes of the Federal securities laws, the Court stated that policy considerations cannot override the statutory text unless "adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it."[10] The Court then cited various policy considerations, including the costs associated with private securities litigation and the potential for vexatious litigation, that Congress might have weighed against the "competing policy arguments in favor of aiding and abetting liability."[11] The Court concluded that "it is far from clear that Congress in 1934 would have decided that the statutory purposes would be furthered by the imposition of private aider and abettor liability."[12]

The four justices who dissented from the Court's decision[13] emphasized the *"hundreds"* of court decisions supporting aiding and abetting liability under Section 10(b) and Rule 10b–5.[14] The dissenting justices argued that a "settled construction of an important Federal statute should not be disturbed unless and until Congress so decides."[15] They also argued that the majority's approach was "anachronistic" because it applied relatively recent case law regarding private causes of action to a statute enacted when it was generally assumed that statutes would carry with them private rights.[16]

The Supreme Court's decision in *Central Bank of Denver* is significant not just because it fundamentally alters the scope of private liability under Rule 10b–5, but also because it reflects the Court's determination to construe strictly the text of the

[4] *See 62 U.S.L.W. at 4238 n.1 (Stevens, J., dissenting) (citing cases).*
[5] 62 U.S.L.W. at 4232.
[6] *Id.* at 4233.
[7] *Id.*
[8] *Id.*
[9] 62 U.S.L.W. at 4236.
[10] *Id.* at 4237 (quoting *Demarest* v. *Manspeaker*, 498 U.S. 184, 191 (1991)).
[11] *Id.* at 4237.
[12] *Id.*
[13] Justice Stevens was joined by Justices Blackmun, Souter, and Ginsburg.
[14] *Id.* at 4238 (Stevens, J., dissenting).
[15] *Id.* at 4239 (quoting *Reves* v. *Ernst & Young*, 494 U.S. 56, 74 (1990) (Stevens, J., concurring)).
[16] *Id.*

Federal securities laws.[17] It is no longer safe to assume that, if there is a gap in the securities laws, the Court will supplement the statutory text to effectuate Congress's underlying policy goals.[18] Instead, Congress should assume that the Court will minimize policy considerations and strictly adhere to the text and structure of the statutes drafted 60 years ago. As the Court stated in *Central Bank of Denver*, the issue "is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."[19]

II. Potential Effect on the SEC's Enforcement Program

The Commission itself has frequently relied on the aiding and abetting theory of liability, not only under Section 10(b) and Rule 10b–5, but also with respect to other substantive provisions that do not explicitly refer to aiding and abetting.[20] Out of about 420 pending Commission cases, we have identified about 80 cases in which the Commission has asserted an aiding and abetting claim not expressly provided by statute. Most of these cases include other counts in which the alleged aider and abettor is charged as a primary violator. In at least 25 pending Commission injunctive actions, however, one or more defendants are charged solely under an aiding and abetting theory of liability.

The Commission has concluded that alternatives to aiding and abetting liability will be available to the Commission in most cases. By asserting primary violations in appropriate cases, and pursuing theories of secondary liability in other cases, the Commission believes that it can maintain a significant portion of its pending enforcement litigation. Where it is not possible to proceed in district court on either a primary or secondary theory of liability, the Commission generally will be able to use its cease and desist authority to address the matter administratively.

Because alternative enforcement options exist, the Commission does not believe that it would be prudent to devote substantial resources to litigate the issue of whether the *Central Bank of Denver* decision applies to Commission enforcement actions.[21] The Commission simply cannot afford to let its enforcement program become mired in litigation in courts across the country regarding the scope of its remedial authority. In our view, the most responsible course for the Commission is to use the alternatives discussed below in most cases, preserving our ability to litigate the issue as appropriate.

Primary Liability. One obvious alternative is to allege primary violations of the acts or rules wherever possible. As the Supreme Court stated:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming *all* of the requirements for primary liability under Rule 10b–5 are met. In any complex securities fraud, there are likely to be multiple violators; in this case, for example, respondents have named four defendants as primary violators.[22]

Although the Supreme Court clearly indicated that not every aiding and abetting claim can be recast in terms of primary liability,[23] the boundaries of primary liability are not clear. One securities law treatise has described the line between primary

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[17] *See also City of Chicago* v. *Environmental Defense Fund*, No. 92–1639 (U.S. May 2, 1994); *Landgraf* v. *USI Film Products*, No. 92–757 (U.S. April 26, 1994); John Biskupic, *Listening In on the "Conversation" Between Court and Congress*, Wash. Post, May 1, 1994, at A4.

[18] *Cf. SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963) (interpreting securities legislation "not technically and restrictively, but flexibly to effectuate its remedial purposes").

[19] 62 U.S.L.W. at 4233–34.

[20] *E.g., SEC* v. *Sands*, Lit. Rel. No. 14051 (April 13, 1994) (Exchange Act Section 13(a)); *SEC* v. *Midwest Investments, Inc.*, Lit. Rel. No. 14049 (April 12, 1994) (Exchange Act Section 15(c)); *SEC* v. *Kagel*, Lit. Rel. No. 14047 (April 7, 1994) (Exchange Act Section 13(a)); *SEC* v. *Morgan*, Lit. Rel. No. 14039 (March 31, 1994) (Exchange Act Sections 15(a)(1), 15(c)(1), 15(c)(3), and 17(a)(1)); *SEC* v. *Gibori*, Lit. Rel. No. 14025 (March 23, 1994) (Securities Act Sections 5 and 17(a) and Exchange Act Sections 10(b), 13(a), and 13(b)); *SEC* v. *Independent Asset Management*, Lit. Rel. No. 14006 (March 15, 1994) (Investment Company Act Section 7(a)).

[21] The dissent argued that the "majority leaves little doubt that the Exchange Act does not even permit the *Commission* to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b–5." 62 U.S.L.W. at 4240 (Stevens, J., dissenting).

[22] 62 U.S.L.W. at 4237–38.

[23] "[A]iding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." 62 U.S.L.W. at 4233.

and secondary liability as "indistinct" and "virtually nonexistent."[24] This uncertainty in the law exists, in large part, because the distinction seldom had any practical significance before the *Central Bank of Denver* decision. Persons who aided and abetted a fraud were held jointly and severally liable with primary violators in private actions, and the Commission obtained the same injunctive relief against primary and secondary violators in its enforcement actions.

Although each case will turn on its facts, the Commission believes that it will generally be able to plead a primary fraud violation against persons, such as accountants, who make statements relied upon by investors. The more difficult situations may involve corporate disclosure cases in which a number of different officers and agents of the corporation play a role in developing the disclosure in question. The Commission also has some concern that precedents regarding the distinction between primary and secondary violators will be established in the context of private actions to which the Commission is not a party.

Liability as a "Cause". A second alternative is to use the Commission's administrative cease and desist authority with respect to persons who act as "a cause" of a securities law violation by another person. Section 21C of the Exchange Act, and parallel provisions in the other acts,[25] allow the Commission to proceed against any "person that is, was, or would be a cause of [a violation of the securities laws or rules], due to an act or omission the person knew or should have known would contribute to such violation." The Commission may order such a person to cease and desist from violating or causing a violation of the relevant provisions, and the Commission may also order an accounting and disgorgement of a violator's illegal profits.[26] In the event that a cease and desist order is thereafter violated, the Commission may seek civil penalties in Federal district court.

The scope of liability as a "cause" of a violation would appear to be as broad, if not broader, than aiding and abetting liability.[27] There are differences, however, between a cease and desist order against a person for "causing" a securities violation and an injunction against a person for "aiding and abetting" a securities violation. A Federal district court injunction, which is punishable by criminal contempt, is generally perceived to be a more severe sanction than a Commission cease and desist order.[28] More importantly, a Federal district court may impose penalties in Commission injunctive actions, but the Commission may not impose penalties in cease-and-desist proceedings.[29]

Besides resulting in milder sanctions in some cases, the inability to pursue aiders and abettors in district court cases will also reduce the efficiency of the Commission's enforcement program. There inevitably will be cases in which the Commission must file an injunctive action in Federal district court against the primary violators, in order to obtain an asset freeze, civil penalties or other appropriate relief, while proceeding separately against secondary violators in a cease and desist proceeding. Having to bifurcate cases in this manner will be a drain on Commission resources.

Controlling Person Liability. In certain cases, the Commission may consider whether a potential defendant has liability as a "controlling person." Section 20(a) of the Exchange Act provides that any person who "controls" any person liable under the Act is liable "to the same extent" as the controlled person, unless the controlling person "acted in good faith and did not directly or indirectly induce" the vio-

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[24] 4 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 8.5(600) (1991). There are some cases under Section 5 of the Securities Act holding that a "necessary and substantial" participant in an unregistered sale of securities is liable as a primary violator. *E.g., SEC* v. *Holschuh,* 694 F.2d 130, 139–42 (7th Cir. 1982). It is unclear, however, whether courts will extend this approach to Section 10(b) of the Exchange Act and other provisions.

[25] *See* Securities Act Section 8A; Investment Company Act Section 9(f); Investment Advisers Act Section 203(k).

[26] *See* Exchange Act Section 21C(e).

[27] There are as yet no cases interpreting the 1990 cease and desist provisions. There are, of course, cases interpreting "a cause" and "knew or should have known" in other contexts. *E.g., Knippen* v. *Ford Motor Co.,* 546 F.2d 993, 1003 (D.C. Cir. 1976) ("should have known" equated with negligence); *R.H. Johnson & Co.* v. *SEC,* 198 F.2d 690, 696 (2d Cir.), *cert. denied,* 344 U.S. 855 (1952) ("a cause" does not mean only "immediate or inducing cause").

[28] "Cease-and-desist authority also will provide the SEC with an alternative remedy against persons who commit isolated infractions and present a lesser threat to investors." S. Rep. No. 337, 101st Cong., 2d Sess. 18 (1990).

[29] With respect to securities firms and persons associated with securities firms, the Commission may join cease and desist proceedings with administrative proceedings under other provisions that expressly authorize penalties for aiding and abetting. *See* Exchange Act Section 21B(a)(2); Investment Company Act Section 9(d)(1)(B); Investment Advisers Act Section 203(i)(1)(B).

lation.[30] Section 20(a) is available to the Commission as well as to private plaintiffs.[31] The controlling person provisions are likely to become more important to the Commission after the *Central Bank of Denver* decision.

Regulatory Changes: In addition to the enforcement alternatives discussed above, the Commission may have certain regulatory alternatives available to it. The Commission will consider the extent to which it may use its rulemaking authority to promulgate rules directly prohibiting conduct that previously has been addressed as aiding and abetting other violations. The Commission has broad authority under Section 23 of the Exchange Act to "make such rules and regulations as may be necessary or appropriate to implement the provisions" of the Act. The Commission also has specific rulemaking authority under certain other provisions.[32] The Commission will explore whether it is feasible to use such authority to address conduct previously characterized as aiding and abetting.

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While these and perhaps other alternatives[33] available to the Commission will enable it to maintain a comprehensive enforcement program, the strength and flexibility of its enforcement powers will be limited in certain types of cases. In some cases or with respect to some defendants, the Commission may have only an administrative remedy and civil money penalties may not be available. In other matters, the Commission may be forced to litigate the same case on two fronts. Congressional action is desirable to remedy these effects of the *Central Bank of Denver* decision on the Commission's enforcement program.

III. Effect on Private Securities Actions

As the Commission stated, both in its testimony before this Subcommittee last June and in the brief filed with the Supreme Court in the *Central Bank of Denver* case, it is critically important that investors have effective remedies under the antifraud provisions of the Federal securities laws. The Commission devotes substantial resources to the detection and prosecution of securities law violations, but it cannot address all such violations. Private actions under the Federal securities laws, and in particular the implied private right of action under Section 10(b) and Rule 10b–5, have long been viewed as a "necessary supplement" to the Commission's enforcement activities.[34] Private securities fraud actions also serve to compensate injured investors, a role that Commission enforcement actions can serve only partially and incidentally.[35]

Although the *Central Bank of Denver* decision will not affect all private securities fraud actions, it substantially dilutes the effectiveness of the private remedy in certain types of cases. As a general matter, the decision may affect private securities litigation more severely than it will affect the Commission's enforcement program. There are at least four reasons for this.

First, as discussed above, the Commission has administrative remedies available to it in certain cases against persons who are "a cause of" or who "aid and abet" a violation. These administrative remedies are not available to private plaintiffs. In order to proceed under Federal law against persons who previously were characterized as aiders and abettors, a private plaintiff will have to establish either that the defendants directly or indirectly committed securities fraud, or that some other theory of secondary liability is available.

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[30] *See also* Securities Act Section 15.

[31] *See SEC* v. *Savoy Industries*, 587 F.2d 1149, 1169–70 (D.C. Cir.), *cert. denied*, 440 U.S. 913 (1978); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975); *SEC* v. *First Jersey Securities, Inc.*, 1994 U.S. Dist. Lexis 5477 (S.D.N.Y. April 26, 1994); *SEC* v. *Netelkos*, 592 F. Supp. 906, 921 (S.D.N.Y. 1984). *But cf. SEC* v. *Coffey*, 493 F.2d 1304, 1318 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974) (prior to 1975 amendment).

[32] *See, e.g.*, Exchange Act Sections 10(b) and 15(c)(1).

[33] Any person who knowingly "aids, abets, counsels, commands, induces, or procures" the commission of a Federal crime is punishable as a principal. 18 U.S.C. §2. Thus, the Federal Government may prosecute criminally any person who provides knowing aid in a criminal violation of the Federal securities laws. This "alternative" will be available to the Commission, of course, only in the most serious cases, and only through the Department of Justice.

[34] *See Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 310 (1985); *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

[35] Disgorgement, which is available in Commission enforcement actions, forces a defendant to give up the amount by which he was unjustly enriched. *See SEC* v. *First City Financial Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989); *SEC* v. *Blavin*, 760 F.2d 706, 713 (6th Cir. 1985). Although the Commission usually makes disgorged funds available to investors, the amount of investor losses often exceeds the defendant's gains. Private actions enable investors to seek compensatory damages for their full losses.

Second, important legal differences exist between Commission injunctive actions and private damage actions under Rule 10b–5. As the Supreme Court emphasized in *Central Bank of Denver*, a private plaintiff under Rule 10b–5 must show, defendant by defendant, that the plaintiff reasonably relied on the defendant's misstatement or omission.[36] The Commission, on the other hand, need not demonstrate reliance in order to obtain an injunction.[37] Failure to establish reliance already results in dismissal of a fair number of private claims,[38] and this may occur more often with respect to defendants who were previously characterized as aiders and abettors.

Third, as the dissent suggests,[39] *Central Bank of Denver* at least casts some doubt on the continued viability of certain other forms of secondary liability under the securities laws, such as *respondeat superior*[40] *and apparent authority.*[41] *These theories are more important to private plaintiffs than they are to the Commission. Respondeat superior* allows private plaintiffs to recover from employers for the actions of their employees without regard to whether the employer acted in "good faith" under Section 20(a) of the Exchange Act. The Commission has rarely attempted to rely on *respondeat superior,*[44] but private plaintiffs frequently use this theory.[45]

Fourth, and perhaps most important, the inability to pursue aiding and abetting claims may result in more cases where the likelihood of recovery does not justify the expected litigation costs. In many financial fraud cases, for example, the issuer that perpetrates the fraud often becomes bankrupt before or just after the fraud is exposed. Although there may be parties who justifiably could be held responsible because they contributed to the fraud, the private plaintiff will have to determine the extent to which these secondary defendants are insulated by *Central Bank of Denver.* If it does not appear reasonably likely that liability can be established on some theory other than aiding and abetting, plaintiffs may simply not bring a Federal securities fraud case at all.

It is possible, of course, that private plaintiffs will decide to pursue State law remedies rather than Federal claims against secondary defendants. At present, we cannot tell how important these alternatives will be or whether they, too, will be affected by the *Central Bank of Denver* decision.

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Because effective private remedies against fraud are essential to investor confidence in the fairness of our securities markets, the Commission believes that Congressional action is needed to restore the proper balance to private securities litigation. If Congress fails to act, the rules governing private securities litigation will continue to be established by court decisions that compromise investor protection by affecting broad categories of cases without regard to their merits. This has already occurred with respect to issues such as the applicable statute of limitations[46] and the availability of aiding and abetting liability in private fraud actions; it will likely recur if other pending issues are left for the courts to resolve.

As the Commission stated in testimony before this Subcommittee last June, it is important to respond to the current litigation environment and to do so in a manner

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[36] *See* 62 U.S.L.W. at 4234; *Basic Inc.* v. *Levinson,* 485 U.S. 224, 243 (1988); *Zobrist* v. *Coal-X, Inc.,* 708 F.2d 1511, 1516 (10th Cir. 1983) (reasonableness).

[37] *See SEC* v. *Rana Research, Inc.,* 8 F.3d 1358, 1359 (9th Cir. 1993); *SEC* v. *Blavin,* 760 F.2d 706, 711 (6th Cir. 1985).

[38] *See, e.g., Mills* v. *Polar Molecule Corp.,* 12 F.3d 1170, 1175 (2d Cir. 1993); *Shlesinger* v. *Herzog,* 2 F.3d 135, 141 (5th Cir. 1993); *Brown* v. *E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993); Atari Corp.* v. *Ernst & Whinney,* 981 F.2d 1025, 1029–30 (9th Cir. 1992); *Davidson* v. *Wilson,* 973 F.2d 1391, 1400–01 (8th Cir. 1992).

[39] "[M]any courts, concluding that § 20(a)'s 'controlling person' provisions . . . are not the exclusive source of liability under the Exchange Act, have imposed liability in § 10(b) actions based upon *respondeat superior* and other common-law agency principles. . . . These decisions likewise appear unlikely to survive the Court's decision." 62 U.S.L.W. at 4240 n.12 (Stevens, J., dissenting) (citations omitted).

[40] *Respondeat superior* is the doctrine that a "master,"including an employer, is responsible for the actions of his "servant," including an employee, while the servant is acting within the scope of his employment. *See* Restatement (Second) of Agency § 219 (1958).

[41] Apparent authority is the doctrine that a principal is liable for the actions of an "apparent agent" if the principal leads a third party to believe that the agent has authority. *See id.* § 8.

[44] *See SEC* v. *Geon Industries,* 531 F.2d 39, 55 (2d Cir. 1976); *SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801, 813 (2d Cir. 1975).

[45] *E.g., Hollinger* v. *Titan Capital Corp.,* 914 F.2d 1564, 1576–77 (9th Cir. 1990) (en banc); *In re Atlantic Financial Management,* 784 F.2d 29 (1st Cir. 1986), *cert. denied,* 481 U.S. 1072 (1987); *Sharp* v. *Coopers & Lybrand,* 649 F.2d 175, 182–83 (3d Cir. 1981); *Marbury Management, Inc.* v. *Kohn,* 629 F.2d 705, 712–16 (2d Cir.), *cert. denied,* 449 U.S. 1011 (1980).

[46] *See Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson,* 501 U.S. 350 (1991).

that distinguishes between proposals that are "tailored specifically to deter meritless actions" and proposals that "fundamentally alter private securities litigation" by unduly restricting meritorious actions.[47] The *Central Bank of Denver* decision eliminates aiding and abetting liability without regard to the merits of particular cases, and for that reason it deserves particular legislative attention.

IV. Conclusion

Just a few years ago, Congress enacted legislation that substantially increased the strength and flexibility of the Commission's enforcement remedies. Due in large part to the expanded administrative remedies made available by that legislation, the Commission will generally be able to address securities law violations that it traditionally had pursued under an aiding and abetting theory of liability. Legislation is necessary, however, to preserve all of the benefits provided by the Remedies Act and to avoid inefficiencies and increased demands on limited resources. Legislation is also needed to restore the ability of investors to pursue meritorious aiding and abetting claims. The Commission looks forward to working with the Subcommittee to resolve the issues raised by this decision.

Thank you.

STATEMENT OF DONALD C. LANGEVOORT

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The Supreme Court's decision in *Central Bank of Denver* v. *First Interstate Bank* is the most dramatic constriction of the scope of Rule 10b–5 since the Rule's adoption more than fifty years ago. Its result is stunning—the abandonment of the private right of action for aiding and abetting, which has been a major feature of securities fraud regulation since at least the 1960's. Equally striking, however, is the Court's method of statutory interpretation. *Central Bank* adopts a "text-only" approach to Section 10(b)'s scope, casting aside precedent, policy and legislative intent as useful interpretive mechanisms. This threatens a number of other devices by which the lower courts had heretofore tried to give the Rule a sensible and pragmatic construction, and will surely migrate to other implied remedies under the Federal securities laws.

I find the Court's reasoning unpersuasive, especially in its treatment of the role of precedent and of Congress' deliberations regarding aiding and abetting over the past decades. But academic criticism is not particularly important right now. The significant questions have to do with the foreseeable impact of the ruling, and whether it reflects good policy or not.

The Probable Impact on Private Rights of Action

Central Bank cuts back on the scope of liability under Rule 10b–5. How much, however, is by no means clear. We should keep in mind that restrictive Supreme Court decisions in this area are not new. The immediate reaction is alarm or celebration, depending on one's perspective. But the lower courts have shown a tendency not to amplify such rulings in subsequent cases but to moderate them, seeking to restore some balance between the restrictionist objectives identified by the Supreme Court and competing concerns about sound investor protection. The Court's *Hochfelder* decision requiring a showing of scienter was followed by an expansion of the use of recklessness as a means of satisfying that requirement. *Santa Fe Industries* provoked a line of authority allowing fiduciary breaches to satisfy the deception requirement so long as the wrongdoing was concealed from investors and might have been remedied in State court. *Chiarella* and *Dirks* restricted the scope of insider trading liability under Rule 10b–5; they were quickly followed by the recognition and explosive growth of the misappropriation theory of liability, which took back much of the ground lost in the Court's rulings. In the jurisprudence of Rule 10b–5, the Supreme Court rarely has had the last word.

While prediction is risky, *Central Bank* could well provoke the same sort of contrarian response. Near the end of the Court's opinion, even the majority acknowledges that primary liability under the Rule need not have a narrow scope. All that is required is that the violator be chargeable with all the elements of a cause of action under the Rule (with special emphasis, perhaps, on reliance). To date, courts

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[47] *Concerning Private Litigation Under the Federal Securities Laws: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. 112 (1993) (testimony of William R. McLucas, Director of the Commission's Division of Enforcement).*

have given little attention to the distinction between primary and secondary liability: It made little difference, since both classes of actors had joint and several liability for their misconduct. Now, the quest to stake out the limits of primary liability will begin in earnest. In so doing, we may well find that many persons who had been treated as aiders and abettors remain within the Rule's scope. Indeed, one court remarked recently that invocation of aiding and abetting has often been a misnomer; primary liability is in fact a better means of describing the wrongdoing in many cases. *Akin* v. *Q-L Investments Inc.*, 959 F.2d 521, 526 (5th Cir. 1992).

Plainly—as the Court recognized—any person who speaks directly to investors in aiding another party's securities fraud is a primary violator under Rule 10b–5. The attorney who writes an opinion letter knowing that it contains materially false information falls into that category, as does an accounting firm that certifies an issuer's financial statements with the same scienter. Here, investors rely not only on the information itself, but directly on the credibility and reputation of the maker. That easily establishes primary liability.

The more interesting question is whether "behind the scenes" participants in the preparation of the fraudulent disclosures are also primarily liable. Take, for example, the situation where a group of corporate officials act in concert to cause the issuer to disseminate false publicity in the form of a press release. As the natural persons who proximately cause investors to rely on the misinformation, they bear direct responsibility as a group for the wrongdoing. Even before *Central Bank*, they would probably be considered primary violators. See *Wool* v. *Tandem Computers Inc.*, 818 F.2d 1433, 1440 (9th Cir. 1987). In the same vein, it is not difficult to add to the list of responsible parties the attorneys, accountants, bankers or the like who allegedly also played some significant role in preparing or disseminating the misinformation.

Indeed, the relatively few judicial decisions that have given much attention to the primary/secondary distinction have shown that primary liability can have a fairly broad scope. In *Molecular Technology Corp.* v. *Valentine*, 925 F.2d 910 (6th Cir. 1991), for example, the Sixth Circuit held that an attorney who assisted a client by reviewing and editing disclosure materials could be a primary, not a secondary, participant in the alleged wrongdoing. See also *SEC* v. *Washington County Utility Dist.*, 676 F.2d 218 (6th Cir. 1982) (primary liability does not require face-to-face contact); *Breard* v. *Sachnoff & Weaver Ltd.*, 941 F.2d 142 (2d Cir. 1991) (finding sufficient allegations against preparer of offering circular, without reference to aiding and abetting); In re *Rospatch Securities Litigation*, [1992] Fed. Sec. L. Rep. (CCH) par. 96,939 (W.D. Mich. 1992). A court so inclined could readily extend this reasoning to those who (with the requisite scienter) provide crucial information for use in the disclosure.

What of participants in a fraud who do not actually play a direct role in preparing false disclosure materials, but who nonetheless are aware of the falsity and otherwise aid the wrongdoer? Here, too, there is some room for breadth, using the same concept of duty that underlies an expansive application of primary liability. In a number of decisions, the courts have held that a person may owe an affirmative duty of disclosure to investors in the situation where investors might reasonably rely on them for the truth. For example, the Eighth Circuit in *Arthur Young & Co.* v. *Reves*, 937 F.2d 1310, 1329–31 (8th Cir. 1991), *cert. denied*, 112 S.Ct. 1165 (1992), found such a disclosure duty in a situation where an accounting firm allegedly remained silent in the face of client fraud. The court emphasized that investors were relying on the firm directly as vouching for the credibility of its client. Such reasoning can plausibly be applied to any number of reputable institutions that are held out to the investing public as associates of the wrongdoer. For a well-known example that might be characterized along these lines, see *Rolf* v. *Blyth Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). Indeed, it is possible that the defendant in *Central Bank* itself—the indenture trustee in a bond offering—might be seen as having such a duty (although the court of appeals did reject that conclusion).

Obviously, we cannot be sure that the courts will take this expansive route. Perhaps the sentiment against private securities litigation will cause them to restrict here as well. Nonetheless, history teaches that there is an ebb and flow to the jurisprudence of Rule 10b–5, and the route toward revitalization seems quite clear. If that route is followed, then the only persons previously considered aiders and abettor who would clearly escape liability are those whose assistance involved no vouching, and who played no role at all in the falsity itself. Lawyers whose only assistance was providing legal services to the client other than preparation of disclosure materials would be free, as would banks who provide financing to a wrongdoer but nothing more. In this regard, however, we should take note that even under the highly unpredictable pre-*Central Bank* law of aiding and abetting, such participants

were frequently avoiding liability. As Professors Loss and Seligman have observed, "[w]hen an alleged aider and abettor . . . does not engage in conduct that intentionally misleads or lulls a victim, the courts have typically been reluctant to impose liability." IX L. Loss & J. Seligman, Securities Regulation 4486 (3d ed. 1992). See *K&S Partnership* v. *Continential Bank*, 952 F.2d 971, 980 (8th Cir. 1991) (absence of investor reliance on the bank); *Schatz* v. *Rosenberg*, 943 F.2d 485 (4th Cir. 1992) (same regarding law firm). We should also remember that aiding and abetting remains a viable theory in private rights of action grounded on State securities law claims. See Branson, *Collateral Participant Liability Under State Securities Laws*, 19 Pepp. L. Rev. 1027 (1992).

Another impact of *Central Bank* on private enforcement bears note. As the dissenters observed, the ruling calls directly into question two other "scope" theories of secondary liability widely recognized by the courts: Conspiracy, and general agency law theories such as respondeat superior. To date, the latter has been the more important. While Section 20(a) of the Exchange Act creates controlling person liability where that defendant has acted in bad faith or somehow induced the violation, that approach has been seen as inadequate to reach the controlling person who is not directly involved but who nonetheless put the primary wrongdoer in a position to commit the fraud. As compared to the innocent victim, the courts have said, the employer should pay. See *Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1577 (9th Cir. 1990); In re *Atlantic Financial Management Corp.*, 784 F.2d 29 (1st Cir. 1986).

Because respondeat superior and related agency theories are not specifically addressed in the statute (and indeed, seem superficially inconsistent with Section 20(a)), they are at risk after *Central Bank*. Even here, however, there is some room for argument. Respondeat superior is a central tenet of tort law, in contrast to the insignificant status the Court found for aiding and abetting the common law scheme. And Section 10(b)'s reference to any "person" expressly includes, by virtue of Section 3(a)(9), companies and other entities as well as natural persons. Plainly, some form of agency law attribution of responsibility is necessary to give effect to Congress' definition. Where the actual wrongdoer speaks in the scope of his or her employment for or on behalf of the employer, it is hardly a radical idea to attribute primary responsibility to the employer. See *Sharp* v. *Coopers & Lybrand*, 649 F.2d 175, 182 n. 8 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982). Even were broader agency law theories to be abandoned, a liberalized interpretation to Section 20(a) might appear to reach situations where the wrongdoing might have been deterred by more effective supervision.

Also of concern, of course, is secondary liability under the other antifraud rules of the securities laws for which private rights of action have been recognized, most notably proxy fraud under Rule 14a–9. Although aiding and abetting and other secondary liability theories have not been utilized as extensively in those other causes of action as under Rule 10b–5, there is little doubt that *Central Bank* will have an impact here, too.

The Probable Impact on SEC Enforcement

If we take the Court literally, then the SEC has lost its ability to charge aiders and abettors with violations of Rule 10b–5. If aiding and abetting is outside the scope of Rule 10b–5, then the Commission is powerless to reach it unless there is separate statutory authority to do so.

Though likely, even this result is not inevitable. In at least one instance, Congress has actually legislated in a way that cannot be explained except by assuming that it believed, for purposes of Commission enforcement proceedings, that Rule 10b–5 *does* reach aiding and abetting. In the Insider Trading Sanctions Act of 1984, Congress added Section 21(b)(2)(B), which stated that no person should be subject to the civil penalty provision "solely because a person aided and abetted a transaction covered by" the primary prohibition, except by tipping. The intent was clearly indicated: Other remedies, including but not limited to administrative proceedings against broker-dealers who execute insider trading transactions for their customers, are sufficient. See H.R. Rep. 355, 98th Cong., 1st Sess. at 10 (1983). Because insider trading is primarily a violation of Rule 10b–5, it is hard to imagine the meaning of this provision except by the assumption that the Rule applies in SEC actions. In *Central Bank*, the Court glossed over this provision, presumably because it had no bearing on the private rights question. Perhaps it would be given more attention when the question of SEC enforcement is squarely raised.

If the SEC does lose the ability to pursue aiders and abettors directly, it will adversely affect the Commission's enforcement program. True, the same expansive potential in the scope of primary liability under Rule 10b–5 exists for the Commission to pursue. In any event, there are alternative remedies: Section 15(c)(4) for those who cause a false filing to be made, Section 15(b) for aiding and abetting by broker-

dealers (with comparable disciplinary mechanisms in the Investment Advisers Act), and Rule 2(e) for lawyers and accountants, whose professional responsibility counsels that they not provide assistance to fraudulent client activity. And there is always criminal reference. But as Congress recognized in enacting the Securities Fraud Enforcement and Penny Stock Reform Act of 1990, more effective sanctions than these are needed to combat securities fraud. The inability to impose civil penalties on aiders and abetters would be a significant loss.

The Policy Question

Even if we are cautiously optimistic that securities fraud litigation may not be narrowed by *Central Bank* as much as it might first seem, the policy question remains. Should Section 10(b) be amended by statute to provide for aiding and abetting liability?

At the outset, let me emphasize that such a simple step might well not be enough. As noted earlier, Central Bank's methodology extends well beyond this single question, casting doubt on a wide range of important secondary liability theories under Rule 10b–5, as well as under other antifraud provisions of the securities laws. The appropriate response, then, is not necessarily an easy one to craft.

From a policy perspective, the propriety of deterring individuals and organizations from giving substantial assistance to those about to engage in securities fraud is clear. Investment and commercial banks, attorneys, accountants and the like often operate as "gatekeepers" to the capital marketplace. See Kraakman, *Gatekeepers: The Anatomy of a Third-Party Litigation Strategy,* 2 J.L. Econ. & Org. 53 (1986). If effective, a form of regulation that creates an incentive to withhold services from miscreant clients and associates can readily help to deter fraud. The need for sanction seems readily apparent. This is especially important when we realize, as Professors Jennifer Arlen and William Carney have recently shown, that securities fraud tends to occur in "final period" settings when managers fear the possibility of insolvency and job loss, and are thus willing to take larger legal risks. Arlen & Carney, *Vicarious Liability For Fraud on Securities Markets: Theory and Evidence,* 1992 U. Ill. L. Rev. 691. Unless otherwise controlled, the temptation to lie is strong and the alternative checking mechanisms of capital marketplace and shareholder monitoring become ineffective. Some other discipline—particularly, aggressive action against those actually responsible for the fraud and those who facilitate it—is necessary. Implicitly, the fact that Congress has already made aiding and abetting a securities law violation a Federal crime reflects this policy.

Because criminal prosecution is no substitute for SEC enforcement in policing the Federal securities law, it seems plain that the SEC should have the ability to impose its full range of civil sanctions on those who aid and abet securities law violations. Any concerns about over deterrence are readily accommodated by the flexible nature of the civil penalties and other sanctions that the Commission can impose. Given the significant risk that Central Bank will be applied to SEC enforcement proceedings, I would support legislation to amend Section 21 of the Securities Exchange Act to make clear that SEC has the same authority to take action against those who aid and abet a violation of the securities laws as it would against a primary violator. I urged this step in testimony before the House Subcommittee on Telecommunications and Finance on the Securities Fraud Enforcement and Penny Stock Reform Act when it was being considered in 1989, and renew that recommendation all the more strongly today. In amending Section 21, I would also provide some mechanism for sanctioning those who control an aider and abettor, along the lines provided in the Insider Trading and Securities Fraud Enforcement Act of 1988.

For private rights of action, the general idea that aiders and abetters should bear some financial responsibility for the frauds that they assist seems equally plain. But so much is wrong with our current system of private litigation that simply reinstating aiding and abetting liability through legislation would be to pass up an important opportunity to rethink the prevailing litigation structure. There is much reason to believe, for example, that the prevailing standards governing who can sue and for how much are excessive and overcompensate investors even in meritorious actions. E.g., Macey & Miller, *Good Finance, Bad Economics: An Analysis of the Fraud on the Market Theory, 42 Stan. L. Rev. 1059 (1990). There is also reason to question whether the scienter requirement under Rule 10b–5 can be applied with sufficient accuracy to some collateral participants to make them good gatekeepers. Langevoort, Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud,* 46 Vand. L. Rev. 75, 115–17 (1993). Perhaps more importantly, both theory and evidence suggests that litigation incentives are sufficiently skewed that the amount of money expended in the litigation and settlement of securities fraud actions is untied from the underlying merits of the actions. While these concerns

apply to all parties to litigation, they are felt most severely by those with little or no primary responsibility for the wrongdoing, often named as defendants largely in pursuit of a deep pocket. This includes some alleged aiders and abettors.

I would be seriously troubled if legislative revision were effectively to give those who substantially and knowingly assist a securities law violation the ability to avoid sanction altogether. Overreaction to the possibility of vexatious litigation is a distinct risk. However, a carefully crafted liability scheme can surely be devised to address questions of fairness and disproportion without unnecessarily compromising reasonable claims of participation in securities fraud, which—sadly—exists in significant amounts in this country. In particular, I would encourage the Congress to:

(1) Create a system whereby class actions charging securities fraud are subject to an immediate evidentiary hearing on the merits, to determine with respect to any or all defendants whether a sufficient factual basis exists for inferring a violation to justify class certification and lengthy discovery;

(2) Impose greater accountability for the conduct of plaintiffs' counsel (including allowing a plaintiff guardian ad litem or supervisory committee to select substitute counsel for settlement negotiation purposes); and

(3) Shift from a compensatory to a deterrence objective in the measurement of damages in securities fraud litigation, by (among other things) moving to a system of proportionate liability.

Legislative initiatives such as S. 1976 as introduced by Senator Dodd and his colleagues, the "Private Securities Litigation Reform Act of 1994," provide an opportunity to address these sorts of reforms. On balance, I would use these to give further consideration to the myriad issues touching on aiding and abetting in private litigation under Rule 10b–5, rather than seeking the quick (and perhaps incomplete) fix of simple statutory overruling.

STATEMENT OF MARK J. GRIFFIN

DIRECTOR, DIVISION OF SECURITIES, UTAH DEPARTMENT OF COMMERCE

ON BEHALF OF THE

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman and Members of the Subcommittee: My name is Mark Griffin. I am Director of the Utah Department of Commerce's Division of Securities and a member of the board of directors of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 State securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

On behalf of NASAA, I appreciate the opportunity to appear before you today to discuss the important issues that have been raised in the wake of the U.S. Supreme Court's decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*[1] In that decision, a divided Court held that there is no private implied right of action for aiding and abetting under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (SEC) Rule 10b–5 thereunder. There can be little disagreement that in this decision the Supreme Court has called upon Congress to express its intent with respect to aiding and abetting liability under Section 10(b). As a result, NASAA respectfully urges Congress to move immediately to adopt legislation expressly codifying aiding and abetting liability under Section 10(b) of the Securities Exchange Act of 1934 and specifically authorizing both private plaintiffs and the Commission to bring actions against violators.

Overview and Executive Summary

The Supreme Court's *Central Bank* decision is the latest in an ever-growing chain of unfortunate decisions that have worked to systematically deprive investors of their rights and remedies under the securities laws, either by restricting their access to the Federal court system or by diminishing their ability to recover losses.[2] Regrettably, the adverse implications of this latest decision may well dwarf those

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[1] No. 92–854 (U.S., April 19, 1994).

[2] This trend may be traced back through such cases as the 1987 decision in *Shearson/American Express, Inc.* v. *McMahon* and the 1989 decision in *Rodriguez* v. *Shearson/American Express, Inc.*, both of which reversed longstanding interpretations prohibiting the use of mandatory predispute arbitration clauses to deprive investors of access to the courts in cases arising under the 1933 and 1934 Federal securities laws. More recently, the Supreme Court in its 1991 *Lampf* decision dramatically shortened the statute of limitations for securities fraud cases.

associated with the Court's earlier rulings because it strikes close to the heart of the antifraud provisions of the Federal securities laws. As a result, defrauded investors today are left with severely restricted means of redress. NASAA believes that this judicial trend is contrary to the intent of Congress and is in direct opposition to the best interests of securities investors and the capital markets.

Curbs on private actions brought by victimized investors—as a result either of procedural restrictions or unrealistically short statutes of limitation—sends the devastating message that fraud no longer will be discouraged and penalized as it has been in the past. Such a message could not come at a worse time and could well erode confidence in the capital markets, reduce investment, and increase the cost of raising capital for U.S. businesses.

NASAA recognizes that this Subcommittee now has under consideration a sweeping package of changes to the current securities litigation system and that some interests will encourage you to address the aiding and abetting issues only within the context of a broader framework. NASAA urges you to resist such an approach in favor of dealing immediately with the narrow, straightforward, and pressing problems caused by the Supreme Court's *Central Bank* decision.

The need for immediate action on the issues raised in *Central Bank* is heightened in view of the advice we understand is now being offered by defense counsel to their clients. One major national law firm sent out a notice on April 22nd to its clients cautioning that: *"There are reports that legislation will be introduced in Congress in response to the Court's decision. Therefore, those clients who are defendants in Section 10(b) cases involving private claims that allege aiding and abetting should* ***immediately*** seek a final judgment dismissing those claims to minimize the impact of new legislation."[3] (Emphasis in original.) Another law firm has suggested to its clients that the implications of this decision may extend well beyond Section 10(b) cases to other actions involving secondary liability.[4]

Mr. Chairman and Members of the Subcommittee, your prompt consideration of the Supreme Court's *Central Bank* decision demonstrates this panel's concern for the investing public and for principles of fair dealing in the securities markets. At stake here is nothing short of the continued confidence of investors in our capital markets, as well as the continued viability of the SEC's enforcement program. It is rare that an issue arises that is as clear cut as the one that is before you today. The *Central Bank* ruling has deprived small investors across the country of their ability to recover losses due to fraud and has called into question the SEC's enforcement capabilities. Congress can correct that. If ever there was a clear clarion call to action on a securities law issue before Congress, this is it.

Private Actions and Aiding and Abetting Liability Under the Securities Laws

The strength and stability of our Nation's securities markets depend in large measure on investor confidence in the fairness and efficiency of these markets. In order to maintain this confidence, it is critical that investors have effective remedies against persons who violate the antifraud provisions of the securities laws. Although the SEC, State securities regulators, and self-regulatory organizations (SRO's) all devote substantial resources to detecting and prosecuting securities law violators, private actions under Section 10(b) of the Securities Exchange Act of 1934[5] serve as the primary vehicle for compensating defrauded investors.[6] The threat of private actions also play an important role in deterring securities law violations.

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[3] "To Our Clients and Friends," an April 22, 1994, memo from Gibson, Dunn & Crutcher.

[4] Harvey Pitt, Fried, Frank, Harris, Shriver & Jacobsen, "Of Deep Pockets, Frivolous Premises and Statutory Makeweights: The Demise of Implied Federal Securities Law Aiding and Abetting Liability," April 29, 1994.

[5] The fundamental purpose of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to ensure full disclosure to investors and to punish those who violate the law. Within this framework, Section 10(b) of the Exchange Act was designed as a "catchall" anti-fraud provision to enable the SEC to handle novel and unforeseen types of securities fraud. Intended as a comprehensive anti-fraud provision operating even when more specific laws have no application, Section 10(b) makes it unlawful to employ in connection with the purchase or sale of any security "any manipulative or deceptive device or contrivance" in violation of the Commission's rules. The courts implied a private right of action under Section 10(b) to encourage private enforcement of this overarching anti-fraud provision of the Federal securities laws.

[6] It also should be pointed out that when a State or Federal regulatory agency files an enforcement action, its principal objectives are to enjoin the wrongdoer from future violations of the law, to deprive violators of their profit by seeking orders of disgorgement, and generally to deter other violations. Private actions, by contrast, enable defrauded investors to seek compensatory damages and thereby recover the full amount of their losses. (*See* statement of William McLucas, SEC Director of Enforcement, before the Securities Subcommittee, Committee on

Continued

In short, private actions under the Federal securities laws are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace. Before the Supreme Court handed down its decision in *Central Bank,* courts in 11 circuits had recognized the importance of aiding and abetting cases brought by private plaintiffs to punish violators of the antifraud statutes.

AIDING AND ABETTING LIABILITY

An important lesson to be learned from the massive financial frauds of the 1980's is that these schemes often involve not only the primary wrongdoers who are central to the criminal enterprise, but also the professionals—such as lawyers and accountants—who aid and abet the fraud. In many instances, these financial crimes could not have succeeded without the participation of the accounting firms and law firms that conferred credibility and advice upon the enterprises. According to Harris Weinstein, former General Counsel of the Office of Thrift Supervision (OTS), ". . . few of the frauds and none of the high-risk schemes could have been undertaken without the active assistance of professionals, including lawyers and accountants."[7] A similar sentiment was expressed by Judge Friendly in *United States* v. *Benjamin:*[8]

> In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or crowbar . . . Congress . . . could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.

Perhaps the most vocal critic of the role that the accounting and legal professions played in assisting the major financial frauds of the last decade has been U.S. District Judge Stanley Sporkin. In his opinion in one savings and loan case, Judge Sporkin wrote:[9]

> Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated?

In a subsequent speech, Judge Sporkin elaborated:[10]

> It is indeed a sad commentary when it is realized that without the complicity of this Nation's lawyers and accountants the financial crimes of the roaring 80's simply would not have occurred. This is an undeniable fact and yet few if any of this Nation's professional or other leaders have spoken out on this subject . . . The stakes are too high and the professions have too large a role in the performance of our private business and financial machinery to shun their responsibilities to make our system perform better.

Aiding and abetting is one of several concepts used in connection with the Federal securities laws to extend liability to persons other than the central wrongdoers when there have been violations of the securities law. It is a judicially created doctrine of secondary liability that is not explicitly found in the Federal securities laws. Although this concept is not explicitly found in Federal securities laws, aiding a violation of Section 10(b) had long been recognized to be actionable for damages; indeed, its recognition was virtually simultaneous with the recognition of a private right of action.

In formulating the doctrine of aiding and abetting in Rule 10b–5 cases, the courts, prior to the *Central Bank* decision, molded section 876 of the Restatement of Torts into three elements for use in the securities fraud context: (1) violation of the securities laws by a primary party; (2) knowledge of that violation by the secondary party; and (3) "substantial assistance" rendered to the primary party by the secondary party.[11] The theory behind this secondary liability is straightforward: When cor-

Banking, Housing, and Urban Affairs, U.S. Senate, June 17, 1993.) Even those who are advocates of strong governmental regulation and oversight acknowledge that the interests of regulators in halting current and future wrongdoing may conflict with the interests of those who have already fallen victim.

[7] John Moore, "The Clubbing Counsel," *National Journal,* July 25, 1992, p. 1714.

[8] *United States* v. *Benjamin,* 328 F.2d 854, 853 (2d Cir. 1964).

[9] *Lincoln Savings and Loan Association* v. *Wall* (D.D.C. August 22, 1990 slip op. at 46).

[10] The Honorable Stanley Sporkin, An Address to the American Law Institute-American Bar Association Conference on Lawyer and Accountant Liability and Responsibility on the Subject of Lawyer and Accountant Liability, December 10, 1993.

[11] Timothy Metzger, "Abandoning Accountants' Liability for Aiding and Abetting 10b–5 Securities Fraud," *Northwestern University Law Review,* Summer 1993.

porate officers, accountants, lawyers, or others involved in the operation of a public company assist in deceiving investors, they should be held accountable for their actions. If this were not the case, investors would be far less willing to participate in the securities markets, and the cost of raising new capital for all American businesses would increase.

THE ROLE OF ACCOUNTANTS IN THE DISCLOSURE PROCESS

Although a securities issuer bears primary responsibility for ensuring that its financial disclosure is both accurate and complete, registration statements filed under the Securities Act and annual reports filed under the Exchange Act are required by statute to include financial statements audited by an independent accountant. As such, accountants play an unique role in securities transactions. The Supreme Court affirmed the public interest nature of auditing in *United States* v. *Arthur Young & Co.*, in which the Court ruled that:[12]

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This **"public watchdog" function** demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. (Emphasis added.)

The American Institute of Certified Public Accountants (AICPA) confirms this public watchdog role in its own Code of Professional Conduct. According to the Code, CPA's are required to "act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism," to "perform all professional responsibilities with integrity," and to "maintain objectivity and be free of conflicts of interest."[13]

There has been in recent years what Joel Seligman, Professor of Law at The University of Michigan Law School, has described as a "disturbing increase in 'audit failures.'"[14] Between 1970 and 1992, the SEC, for example, brought one hundred and twenty Rule 2(e) disciplinary proceedings against accountants for violations of professional standards, for an average of just over five cases per year.[15] By contrast, in 1993 alone, the SEC brought twenty-two Rule 2(e) proceedings against accountants. In testimony before this Subcommittee last year, William McLucas, the SEC's Director of the Division of Enforcement testified that: "Last year, 69 of the Commission's approximately 395 enforcement actions primarily involved financial disclosure or accounting issues. These types of cases averaged roughly 15 percent of the enforcement actions brought by the Commission over the last 10 years."[16]

Public confidence in the financial reporting system has been shaken in recent years by highly publicized business failures. These events have raised questions about the effectiveness of the independent audit function and the integrity, objectivity, and competence of independent auditors. For example,[17] in 1992 Ernst & Young agreed to pay $400 million to settle United States regulatory agency claims against it for audits of four failed thrift institutions. During the same year, Coopers & Lybrand agreed to pay at least $140 million to settle claims brought by bondholders, creditors, and investors related to the firm's work for the now defunct MiniScribe Corporation. At the trial, a CPA serving as an expert witness testified that Coopers & Lybrand had overlooked improper revenue recognition procedures and allowed inadequate reserves for bad debts and returned merchandise. Deloitte & Touche was charged by the RTC with negligence, breach of contract, aiding and abetting, and breach of fiduciary duty in its audits of the failed CenTrust Bank.

To its credit, the accounting profession has recognized the need for more stringent professional standards and has undertaken a program to, among other things: improve the prevention and detection of fraud; enhance the utility of financial reporting to those who rely on it; assure the independence and objectivity of the independ-

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[12] *United States* v. *Arthur Young & Co.*, 465 U.S. 805 (1984).

[13] AICPA, *Code of Professional Conduct*, 1992.

[14] April 25, 1994, letter from Joel Seligman to Craig A. Goettsch, President, NASAA. (Mr. Seligman is a Professor of Law at The University of Michigan Law School and coauthor with Harvard Law School's Professor Louis Loss an 11 volume treatise on Securities Regulation.)

[15] *Ibid.*

[16] Statement of William McLucas, Director of the SEC's Division of Enforcement, before the Securities Subcommittee, Committee on Banking, Housing, and Urban Affairs, "Concerning Private Litigation Under the Federal Securities Laws," June 17, 1993, page 4.

[17] *See*, April 25, 1994, letter from Seligman to Goettsch and the report of Public Citizen/U.S. Public Interest Research Group, "Bad Audits . . . Not Deep Pockets: Illustrations of Failed Audits by the BIG 6," July 21, 1993.

ent auditor; and strengthen the accounting profession's disciplinary system.[18] However, it is clear that, in order to encourage accountants and other professionals to live up to their public responsibilities, it is necessary to have in place a strong and effective system of liability that can be imposed when the public trust is violated.

Due to their critical role in the disclosure process, accountants are among the parties most frequently sued in private actions involving secondary liability. Indeed, although not the first to consider claims of aiding and abetting 10b–5 securities fraud, the court in *Fischer* v. *Kletz*[19] generally is believed to have pioneered the development of the aiding and abetting concept in the context of accountants' liability. The significance of the *Fischer* decision lies in its direct recognition of the unique role that accountants play in securities transactions. The decision paved the way for accountants' liability based on the secondary theory of aiding and abetting despite the lack of express statutory authority for such an approach.

The concept of liability for aiding and abetting based on a duty arising from a special relationship or duty is perhaps best stated in *Brennan* v. *Midwestern Insurance Co.*, in which the district court stated:[20]

> Certainly, not everyone who has knowledge of improper activities in the field of securities transactions is required to report such activities. This court does not purport to find such a duty. Yet, duties are often found to arise in the face of special relationships, and there are circumstances under which a person or a corporation may give the requisite assistance or encouragement to a wrongdoer so as to constitute an aiding and abetting by merely failing to take action.

Soon thereafter, accountants' liability for aiding and abetting 10b–5 securities fraud gained universal, if sometimes skeptical, acceptance among the Federal courts of appeals.[21] As such, the aiding and abetting theory often has been the primary or exclusive basis for holding accountants liable for recklessly performed audits of securities issuers' financial statements.[22]

The Supreme Court's Decision in Central Bank

In one of the most important decisions in many years, the U.S. Supreme Court on April 19, 1994, issued its decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.* By a 5–4 vote, the Court's majority held that there is no private implied right of action for aiding and abetting under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Rule 10b–5. In so deciding, the Court overruled decades of precedent from 11 Federal courts of appeals that had recognized a private cause of action against aiders and abettors under Section 10(b) and Rule 10b–5.

The parties to the case understandably had assumed aiding and abetting liability, but disputed its scope. The Court asked them to address whether such liability even exists, an issue on which the Court had reserved judgment for 18 years. The Court found that Congress did not intend that an aiding and abetting cause of action be implied under Rule 10b–5, since that language is absent from every express securities law private remedy and the Court opined that "statutory silence cannot be interpreted as tantamount to an explicit congressional intent to impose Section 10(b) aiding and abetting liability."[23]

The four dissenting justices in Central Bank took a different view:[24]

> In *hundreds* of judicial and administrative proceedings in every circuit in the Federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under Section 10(b) and Rule 10b–5 . . . All 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under 10(b) and Rule 10b–5.

The dissenting justices further observed that: ". . . the right fits comfortably within the statutory scheme, and it has become a part of the established system of private enforcement."[25] Significantly, the dissent pointedly declared that the "Majority leaves little doubt that the Exchange Act does not even permit the *Commis-*

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[18] Board of Directors of the American Institute of Certified Public Accountants, "Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession," June 1993.

[19] *Fisher* v. *Kletz,* 266 F. Supp. 180 (S.D.N.Y. 1967).

[20] *Brennan* v. *Midwestern Insurance Co.*, 259 F. Supp. 673, 681–82 (N.D. Ind. 1966), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970).

[21] Metzger.

[22] Seligman.

[23] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 92–854.

[24] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 92–854, Dissent.

[25] *Ibid.*

sion to pursue aiders and abettors in civil enforcement actions under Section 10(b) and Rule 10b–5."

Mr. Chairman and Members of the Subcommittee, you will hear testimony from many experts who will provide a detailed legal analysis of the Supreme Court's *Central Bank* decision. I would like to focus my remarks on what NASAA believes will be the real world effect of this decision. In that vein, I would offer the following general observations:

- ***Reduced accountability.*** As a result of the decision, accountants and attorneys who depart from professional standards will not be held responsible, except in those instances where the SEC institutes Rule 2(e) proceedings.
- ***Less recovery for investors.*** As a result of the decision, one primary means of providing recourse for many defrauded investors has been eliminated.
- ***Greater strain on an already overburdened SEC.*** As a result of the decision, a premium will be placed on SEC-initiated enforcement actions. There will be pressure on the Commission to bring more actions in view of the fact that certain conduct may not be redressable by private parties. Although the Supreme Court's decision called into question the SEC's authority to bring these actions, they may be reachable by the Commission in an administrative forum or through other means.
- ***"Ripple effect" threatening other forms of secondary liability.*** As a result of the decision and what we expect will be creative maneuvers by the defense bar, other forms of secondary liability may be at risk. The majority's approach to aiding and abetting at the very least casts serious doubt, both for private actions and SEC actions, on other forms of secondary liability that, like the aiding and abetting theory, have long been recognized by the Commission and the courts but are not expressly spelled out in the securities statutes.
- ***Undercuts investor protection standards and threatens capital formation.*** As a result of the decision, it will be measurably more difficult to enforce the securities laws, thus reducing investor confidence and possibly adversely impacting the ability of U.S. businesses to raise capital.

The reality is that investors now will be forced to rely on redress opportunities that may be available under State statutes, rather than relying on an uniform, national standard. A preliminary analysis of State laws reveals that a majority of States operate under statutes which allow for private rights of action affecting only the sellers and buyers of securities. At the same time, most States also have on the books specific statutes that provide secondary liability for non-sellers and non-purchasers, specifically those who directly or indirectly control the sellers and buyers, directors, officers, partners, agents, employees, and broker-dealers. However, some question remains whether the definitions contained in these State laws include accountants, attorneys, or other professionals retained by the sellers and buyers. Eight States have specific language expanding secondary liability and in one instance the State's law is ambiguous. (The attached map displays the status of current State laws.)

The case law regarding secondary liability under State laws is not well developed, apparently as a result of the fact that most litigants have relied almost exclusively on the Federal 10b–5 remedy or the State right was implied from Federal law. Based on case law, another 11 States appear to provide expanded secondary liability for aiding and abetting. This survey of State laws makes it clear that, absent a Federal legislative override of *Central Bank,* investors' recovery for aiding and abetting secondary liability will depend in large measure on where they reside.

Conclusion: Congress Should Adopt Aiding and Abetting Legislation

While it is indisputable that the Supreme Court's decision in *Central Bank* has seriously jeopardized the ability of private plaintiffs to enforce the securities laws and has called into question the Commission's authority to do the same, the Court in several instances invites Congress to legislate in this area. For example, on behalf of the majority, Justice Kennedy wrote: "to be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances . . . The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy, but whether aiding and abetting is covered by the statute." The Court is not hostile to aiding and abetting liability, it simply has asked Congress to signal its intent on this issue.

As a result, NASAA respectfully encourages Congress to enact limited legislation to reverse the Supreme Court's *Central Bank* decision and to explicitly restore the authority under Section 10(b) and Rule 10b–5 for the SEC and private litigants to bring appropriate actions against persons who aid and abet securities fraud. Such legislation is essential to maintaining the integrity of the marketplace and to providing defrauded investors with adequate means of redress. Aiding and abetting li-

ability has played a crucial role in helping taxpayers and defrauded investors recover some of their losses from the unprecedented financial frauds of the last decade. In addition, the prospect of potential liability for aiding and abetting has served as a powerful deterrent that effectively and efficiently supplemented the SEC's efforts to enforce the securities laws. It is essential that this remedy be preserved.

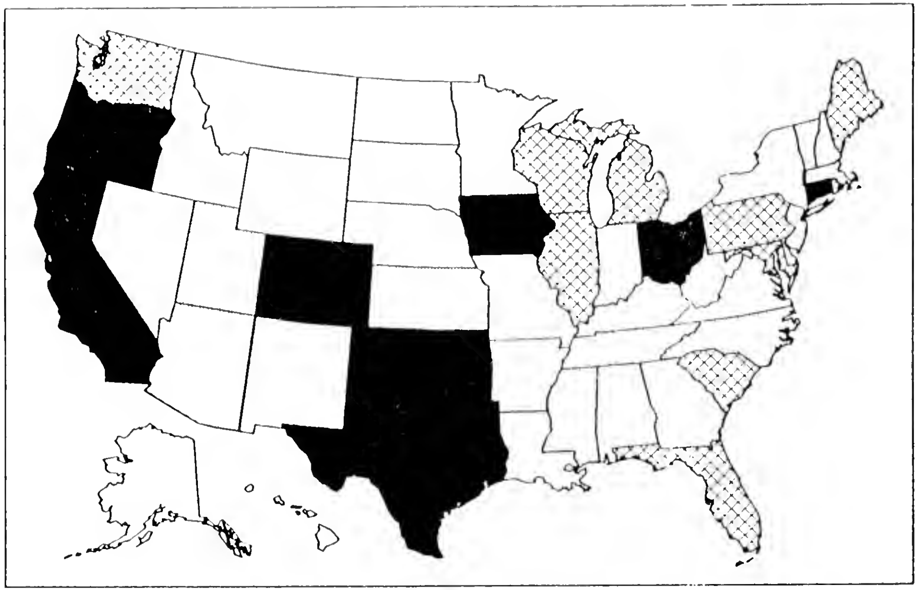
Congress now will be left to determine the precise formulation of the standards for aiding and abetting liability under Section 10(b) and Rule 10b–5. While the circuit courts have taken varying approaches to this issue, in general a plaintiff has had to prove three elements in order to impose aiding and abetting liability on a defendant: (1) the existence of a primary Section 10(b) violation by another; (2) knowledge of the securities violation on the part of the alleged aider and abettor; and (3) substantial assistance by the alleged aider and abettor in achieving the primary violation. NASAA at this time will refrain from suggesting the standards to be applied under the knowledge and substantial assistance requirements, except to generally comment that the standards should not be so high as to render the legislation meaningless in practical effect. NASAA offers its assistance to work with you and your staffs as you develop legislative language in this area.

Mr. Chairman and Members of the Subcommittee, stripped of legal analysis and reasoning, and translated into lay English, a failure by Congress to legislate in this area will force us to admit to investors that, "Yes, you may have been defrauded. Yes, some other person may have materially assisted the primary violator, perhaps even opening the door for the primary violator to have committed the primary fraudulent act. And this assistance might have taken place openly, recklessly, and maybe even with substantial personal benefit. However, no matter how unfair it may seem, Federal law places this secondary violator beyond your reach." This is not a conversation I would want to have with a defrauded investor, particularly when there is the opportunity to correct the situation.

Thank you.

ATTACHMENT____

Blue Sky Aiding and Abetting Laws



■ Statutorily expanded aiding & abetting liability

Judicially expanded aiding & abetting liability

Statute ambiguous -- no judicial interpretation

No aiding & abetting by judicial interpretation

No judicial interpretation of uniform statute

STATEMENT OF STUART J. KASWELL

SENIOR VICE PRESIDENT & GENERAL COUNSEL, SECURITIES INDUSTRY ASSOCIATION

Summary

- The securities industry makes vital contributions to the U.S. economy. In 1993 the securities industry raised over $2.4 trillion for businesses and Federal, State, and local governments.
- SIA participated as *amicus curiae* before the Supreme Court in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230 (April 19, 1994). SIA believes that the case was correctly decided as a matter of law and as sound public policy.
- SIA believes strongly in strong investor protections and adequate remedies for victims of fraud. At the same time, the private civil liability system under the Federal securities laws works poorly.
- The result is, in effect, a "litigation tax" on public companies and securities professionals, with the costs ultimately passed on to shareholders. This tax is most keenly felt by new or medium-sized high technology companies.
- Secondary liability under the securities laws is a particular problem because its application is uncertain and because it allows plaintiffs to sue parties who have not engaged in fraud.
- The Federal securities laws continue to provide a strong and comprehensive system of investor protections. These protections include remedies available to the Securities and Exchange Commission, which has explicit statutory authority to bring administrative proceedings against secondary participants, and the securities self-regulatory organizations. There also exists an extensive system of private remedies.
- Accordingly, Congress should not attempt a "quick fix" on secondary liability, but rather should continue its comprehensive review of the securities litigation system.

I. Introduction

Chairman Dodd, Senator Gramm, and Members of the Subcommittee: The Securities Industry Association[1] appreciates this opportunity to testify concerning the Supreme Court's recent decision in *Central Bank of Denver*[2] that there is no implied right of action against "aiders and abettors" under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b–5.

SIA's members make vital contributions to the U.S. economy. In 1993 the securities industry raised over $1 trillion—$920 billion in debt and $130 billion in equity—for corporate America to expand plants, to develop new products, and to provide jobs. Securities firms also raised almost $300 billion for State and local governments. This means money to finance infrastructure projects, such as schools, businesses, and roads. In addition, securities firms underwrote over one-half trillion dollars in securities for the Federal Government. When one adds-in private placements, the securities industry raised $2.4 trillion in capital in 1993.

SIA participated as *amicus curiae* in *Central Bank of Denver* and believes that the Supreme Court made the right decision, both because it correctly interpreted Section 10(b) and also because limiting secondary liability represents the best public policy. SIA has previously testified before this Subcommittee on the importance of the principle of investor protection and the need for adequate remedies for victims of fraud.[3] At the same time, we testified that the private civil liability system under the securities laws has not served the public at large well and has imposed disproportionate and dysfunctional burdens on issuers, underwriters, accountants, and others.

We believe that the Federal securities laws should continue to provide strong deterrence against wrongdoing and adequate remedies for defrauded investors, yet not

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[1] The Securities Industry Association is the industry's trade association representing the business interests of more than 700 securities firms in North America. Its members include securities organizations of virtually all types—investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchange. SIA members are active in all exchange markets, in the over-the-counter markets and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for about 90 percent of securities firm revenue in the United States.

[2] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230 (April 19, 1994).

[3] *See* Statement of Marc E. Lackritz, President, SIA, Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (July 21, 1993) [hereinafter "Lackritz Testimony"].

impair the capital-raising ability of U.S. businesses and Federal, State, and local governments. These twin goals counsel against Congress enacting a "quick-fix" that imposes secondary liability. Instead, Congress should continue its comprehensive review of securities litigation. The purpose of this review should be to eliminate frivolous litigation, brought not on the merits, but simply for the purpose of enriching lawyers and professional plaintiffs.

II. Discussion

A. BACKGROUND

The *Central Bank* case arose from a public building authority's default on bonds issued to finance improvements of a planned residential and commercial development. Purchasers of the bonds brought suit against the authority, the underwriters, and a director of the developer, alleging primary violations of Section 10(b). The complaint also sought recovery against the Central Bank of Denver, the indenture trustee for the bond issue, on the asserted ground that, because of the bank's delay in obtaining an independent appraisal of the subject property until after the closing of the bond issue, the bank "was 'secondarily liable under Section 10(b) for its conduct in aiding and abetting the fraud.'" 62 U.S.L.W. at 4231.

The district court granted Central Bank's motion for summary judgment, but the Tenth Circuit reversed. Central Bank's certiorari petition to the Supreme Court raised the question of the appropriate scienter standard for Section 10(b) aiding and abetting claims. The Court granted review of this question, but also asked the parties to address the question whether a private action against Section 10(b) aiders and abettors existed.[4]

Ultimately, the Court determined that aiding and abetting liability did not, in fact, exist and therefore did not reach the scienter issue. Writing for the majority (Chief Justice Rehnquist and Justices Kennedy, O'Connor, Scalia, and Thomas), Justice Kennedy stated that the statutory text of Section 10(b) "itself resolves the case." *Id.* at 4234. He observed that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act" and "reach[ed] the uncontroversial conclusion" that the text of the [Exchange] Act does not itself reach those who aid and abet a § 10(b) violation." *Id.* at 4233. Accordingly, the Court held that the text of Section 10(b) does not permit recognition of a cause of action for aiding and abetting: "We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." *Id.* at 4234.

The Court buttressed its holding with the analysis applied in *Musick, Peeler & Garrett* v. *Employers Insurance of Wausau,*[5] *which seeks "to infer 'how the 1934 Congress would have addressed the issue had the 10b–5 action been included as an express provision in the [Exchange] Act.'" Id.* (quoting *Musick, Peeler,* 113 S. Ct. at 2089). Applying the *Musick, Peeler* standard, the Court concluded: "From the fact that Congress did not attach private aiding and abetting liability to any of the express causes of action in the securities Acts, we can infer that Congress likely would not have attached aiding and abetting liability to § 10(b) had it provided a private § 10(b) cause of action." *Id.*

Having found that "[t]he text [of Section 10(b)] does not support" imposition of aiding and abetting liability, the Court had no difficulty disposing of arguments made by the respondents and the Securities and Exchange Commission ("SEC") based upon "a broad-based notion of congressional intent." *Id.* Specifically, the Court rejected the SEC's argument that Congress intended for common law principles of aiding and abetting liability to be incorporated implicitly in the Exchange Act. *Id.* at 4235. The Court noted that, although there is a general criminal aiding and abetting statute, codified at 18 U.S.C. § 2, "Congress has not enacted a general civil aiding and abetting statute," but rather "has taken a statute-by-statute approach to civil aiding and abetting liability." *Id.* Thus, the Court reasoned, had Congress intended to impose aiding and abetting liability under Section 10(b), it would have explicitly imposed such liability in the Exchange Act. *Id.* at 4235.

Stated simply, the decision stands for the unremarkable proposition that statutes are to be interpreted according to their terms.

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[4] Before the *Central Bank* decision, the circuits had been split and uncertain as to the existence of secondary liability under Rule 10b–5, with the Seventh Circuit in effect limiting liability to those who directly violate the rule, *Barker* v. *Henderson, Franklin, Starnes & Holt,* 797 F.2d 490, 495 (1986), and the Fifth and Ninth Circuits questioning the existence of secondary liability. *See, e.g., Akin* v. *Q-L Investments, Inc.*, 959 F.2d 521, 525 (5th Cir. 1992); *SEC* v. *Seaboard Corp.*, 677 F.2d 1301, 1311 n.12 (9th Cir. 1982).

[5] 113 S. Ct. 2085 (1993).

B. The Price of Broad Liability

While many would seek to focus the Subcommittee exclusively on the desirability of providing full compensation to injured investors, we believe that attention should also be paid to the costs to U.S. business and to financial intermediaries and professionals that resulted from the judicially created scheme of secondary liability adopted by many lower courts. These are the same considerations that in 1933 and 1934 prompted the Seventy-Third Congress to strike a careful balance between remedies and defenses to liability.

From a public policy viewpoint, the balance between providing remedies and encouraging capital formation has, in recent decades, swung too far toward remedies. For that reason, this decision—although by itself not likely to make a meaningful dent in the courts' securities class action caseload—is a welcome step in the right direction. As the SIA has previously testified before this Subcommittee, the securities class action system—which encourages strike suits whenever a stock price drops—in effect amounts to a "litigation tax" on capital formation.[6] This "tax" drains funds that would otherwise be available to produce new products, expand plants, or hire more workers. SIA believes many of these suits are brought without merit by aggressive trial lawyers and their professional plaintiffs. As previously indicated, in our view, these suits often are brought to coerce a settlement.[7]

Moreover, a disproportionate share of securities class action suits are against young, medium-sized high technology firms.[8] New businesses are usually less able to withstand the litigation tax. Yet, at the same time, these newly formed and emerging companies most often make initial public offerings to raise the capital needed to grow and prosper. These companies are also the greatest source of new-job creation in the U.S. economy. The Supreme Court itself recognized in *Central Bank* that the effects of securities litigation are especially felt by emerging companies:

> [N]ewer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others.

62 U.S.L.W. at 4237.

The litigation tax also benefits foreign companies and penalizes domestic companies. Foreign companies raising capital overseas are free of this burden, thereby lowering their costs. Foreign companies may choose not to sell their securities here, in some measure because of the fear of exposure to America's litigation costs. As a consequence, the litigation system may deprive American investors of worthwhile investment opportunities and may diminish the competitive position of American capital markets.

At the same time, American entrepreneurs facing higher capital costs will simply not start businesses, or will send their ideas and expertise to countries with lower capital costs. We all pay a penalty for the litigation tax in the form of higher capital costs, the creation of fewer jobs, and the production of fewer products, resulting in a diminished competitive position in the world.

Litigation costs also affect securities firms, accountants, attorneys, and others who also must pay portions of strike suit settlements. Inevitably, these firms must charge higher fees to issuers to offset the costs of litigation or must shun higher risk businesses, making it more difficult for new or innovative businesses to raise capital.

Although there are a number of troublesome aspects to securities litigation, secondary liability has an especially deleterious effect on capital formation because its contours are vague and elastic. As the Supreme Court observed in its decision, the "rules for determining aiding and abetting liability [under the lower court's decisions] are unclear in 'an area that demands certainty and predictability.'"[9] The re-

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[6] *See* Lackritz Testimony at 15–17.

[7] *Id.* at 9–15.

[8] *See* Statement of Vincent E. O'Brien, Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, U.S. Senate at 2 (June 17, 1993).

[9] 62 U.S.L.W. at 4237 (citation omitted). In fact, the Solicitor General's Office, in its brief urging the Supreme Court to grant certiorari, cited this lack of certainty as a reason the Court should take the case. Brief of the United States at 5–6. SIA made this same point in its brief on the merits in *Central Bank:*

> With respect to the "knowledge" requirement, courts have established unique but amorphous and unpredictable rules applicable only to the aiding and abetting right of action that variously require proof of "actual knowledge" in some circumstances and some form of "recklessness" in others, depending on a number of variables such as duties owed to the plaintiff, the nature of the alleged assistance to the primary violator and, in some jurisdictions, a highly fact-specific

sult is interminable litigation and uncertainty for those, like accountants, attorneys, banks, and securities firms, most likely to be drawn into cases under secondary theories of liability. As a consequence, the costs of these professionals' services rise, with the higher costs likely to be passed on to public companies and their shareholders.[10]

Moreover, secondary liability, coupled with the securities laws' application of joint and several liability, could result in peripheral and incidental actors unfairly bearing the entire liability for the intentional frauds of others.[11] A primary Section 10(b) violation generally is understood to include the following elements: (1) use of an instrumentality of interstate commerce; (2) the making by the *defendant* of a material misrepresentation or omission; (3) an intent to deceive, manipulate, or defraud (scienter); (4) reliance by the plaintiff on the defendant's misrepresentation;[12] (5) causation; and (6) damages flowing from the defendant's misconduct.[13] Also, if the Section 10(b) primary violation is predicated on the defendant's failure to disclose material information (*i.e.*, an omission case), the plaintiff must prove that the defendant had assumed a duty to disclose.[14] By contrast, recovery could be had against those found secondarily liable even if they had not engaged in any fraudulent conduct, they owed no duty to the plaintiff, they had no actual knowledge of the underlying fraud, and the plaintiffs had not relied upon their conduct. In effect, secondary liability could result in secondary participants being liable under a far lesser standard than that to which primary violators are subject.

C. EXISTING INVESTOR PROTECTIONS

1. SEC Remedies

It is also important to note that, even without secondary liability for violations of Section 10(b), investors are well protected. The SEC has a full arsenal of remedies to police the markets. The SEC can still go to court to enjoin those who commit primary violations[15] of Section 10(b)[16] and to obtain disgorgement and substantial civil money penalties against them.[17] The SEC, by statute, has full authority in its administrative proceedings to discipline broker-dealers,[18] investment advisers,[19] other regulated entities,[20] and their associated persons for aiding and abetting securities law violations (including Section 10(b) violations). Possible sanctions include suspension or revocation of registration or right of association as well as civil money penalties of up to $100,000 per violation for a natural person and up to $500,000 per violation for others.[21]

Broker-dealers in particular are subject to a comprehensive scheme of regulation. In addition to the SEC, the securities self-regulatory organizations ("SRO's"), such as the New York Stock Exchange and the National Association of Securities Dealers, Inc. ("NASD"), regulate the conduct of broker-dealers and bring proceedings against their members and associated persons for violations of the securities laws and also of SRO rules, which provide even broader investor protections than do the securities

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"sliding scale" of culpability. . . . Moreover, the "substantial assistance" element of the proposed § 10(b) implied private right for aiding and abetting has spawned yet another separate and complex doctrinal quagmire.

Brief of SIA at 8–9 (citations omitted). Enacting a "quick-fix" solution that merely restored aiding and abetting liability without imposing limitations on liability and setting clear standards would merely plunge us back into this quagmire.

[10] 62 U.S.L.W. at 4237.

[11] While the right to contribution recognized by the Supreme Court in *Musick, Peeler* somewhat mitigates the effects of joint and several liability, the right to contribution is not always effective.

[12] *But see SEC* v. *Rana Research*, 8 F.3d 1358 (9th Cir. 1993) (holding that SEC need not prove reliance).

[13] *See, e.g., Weitzman* v. *Stein*, 436 F. Supp. 895, 902–04 (S.D.N.Y. 1977).

[14] *See Chiarella* v. *United States*, 445 U.S. 222 (1980); *Dirks* v. *SEC*, 463 U.S. 646 (1983).

[15] The SEC staff has estimated that less than 10 percent of its pending injunctive actions involve only aiding-and-abetting violations. *See* Wall St. J., May 6, 1994, at C15.

[16] Or, the comparable antifraud provision found in Section 17 of the Securities Act of 1933 ("Securities Act").

[17] Section 21(d) of the Exchange Act.

[18] Section 15(b) of the Exchange Act.

[19] Section 203 of the Investment Advisers Act of 1940 ("Advisers Act").

[20] *See, e.g.,* Sections 15B (municipal securities dealers) and 15C (Government securities dealers).

[21] *See, e.g.,* Section 21B of the Exchange Act (covering broker-dealers, municipal securities dealers, Government securities dealers, transfer agents, clearing agencies, and their associated persons).

laws themselves. These proceedings may lead to substantial fines,[22] orders of restitution, and/or revocation of membership.

The SEC's Rule 2(e), which governs the practice before the SEC of attorneys and accountants, authorizes the SEC to suspend, revoke, or place limitations on the right of any attorney or accountant to appear before the agency if it finds that the individual violated any provisions of the securities laws or aided or abetted another's violation, including a violation of Section 10(b).

Most broadly, under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act"),[23] the SEC can issue a cease-and-desist order against any person who violates any provision of the Exchange Act or against any person who "is a cause of a violation, by reason of any act or omission which he knew or should have known would contribute to a violation."[24] In the case of broker-dealers and other regulated entities, the SEC can also impose a temporary cease-and-desist order, on an ex parte basis if necessary, to prevent a continuing violation or to prevent dissipation or conversion of assets. Violations of either a temporary or permanent cease-and-desist order can subsequently result in large civil money penalties. This statutory provision essentially gives the SEC the explicit authority to punish those secondarily liable for Section 10(b) violations.

Finally, in the most egregious cases, aiders and abettors of Section 10(b) violations can be criminally charged by virtue of Section 32 of the Exchange Act (making any willful violation of the statute a criminal offense) and 18 U.S.C. § 2 (the general criminal aiding-and-abetting statute).

2. Private Remedies

Of equal significance, the Supreme Court's decision leaves genuinely defrauded investors with a broad array of carefully crafted and comprehensive private remedies.[25] The Securities Act provides three express remedies. The most important of these, Section 11, permits an investor to bring an action based upon material misstatements or omissions in a registration statement on file with the SEC. Possible defendants include the issuer, its directors, its chief executive officer, chief financial officer, and chief accounting officer (all of whom must sign the registration statement), accountants and other experts (to the extent that they have prepared or certified any part of the registration statement), and the underwriters. The issuer is absolutely liable for misstatements, and other possible defendants may escape liability only if they can show that, after reasonable investigation, they had reasonable ground to believe that the statements were true and that there were no material omissions of any fact necessary to make the statements not misleading.

Section 12(2) permits recovery by an investor against a person who sells a security, whether registered or unregistered, by means of an oral or written communication which contains a material misstatement or omission. Section 12(2) provides the seller a defense, similar to that in Section 11, that he did not know, and could not reasonably have known, of the misstatement or omission.[26]

These remedies sweep broadly. Most importantly, plaintiffs need not show knowledge of a statement's falsity or recklessness on the part of a defendant.[27] Issuers are absolutely liable, and others must show, essentially, that they were not negligent in not knowing of the misstatement. The ability to assert a so-called "due diligence" defense under Sections 11 and 12(2) provides a powerful incentive for officers, directors, accountants, lawyers, and investment bankers to investigate the accuracy of statements made in public offerings. Moreover, in most instances a plaintiff need not show reliance on the misstatement or omission. Finally, liability under these provisions is joint and several, subject in the case of Section 11 to a defendant's right to recover contribution from others.

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[22] In the case of the New York Stock Exchange and NASD, there is no upper limit on the amount of fine.

[23] Pub. L. No. 101–429, 104 Stat. 931.

[24] *Id., § 203 (adding new Section 21C of the Exchange Act). Similar authority was also added to the Investment Company Act of 1940 and the Advisers Act by Sections 301 and 401 of the Remedies Act.*

[25] The following description of private remedies under the Federal securities laws is intended as a general guide and does not purport to delineate precisely the elements of each remedy or all possible defenses to liability.

[26] The third remedy appears in Section 12(1). Under that provision, an investor who purchases a security offered or sold in violation of Section 5 of the Act (requiring registration of public offerings) has an absolute right of rescission.

[27] By contrast, the Supreme Court has held that, in a claim under Section 10(b) that a plaintiff must show that the defendant acted with "scienter." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). The court left open whether scienter required proof of actual knowledge or could be demonstrated by proof of recklessness. *Id.* at 194 n.2.

The Securities Act also expressly recognizes secondary liability under certain circumstances. Section 15 provides that a person who controls a person who is liable under Section 11 or 12 is also liable unless "the controlling person had no knowledge of or reasonable ground to believe in the existence of the acts by reason of which the liability of the controlled person is alleged to exist."

The Exchange Act contains several express causes of action: Section 9(e) (against persons who "participate" in manipulations of exchange-listed securities), Section 16(b) (against officers, directors, and 10 percent shareholders who obtain "short-swing" profits), Section 20A (against insider traders in favor of contemporaneous purchasers or sellers),[28] and Section 29 (providing for voidability of contracts made in violation of the Act). Over the years, these express remedies under the Exchange Act have been overshadowed by implied remedies created by the courts, the most commonly invoked being that created under Section 10(b) of the Act and Rule 10b–5 thereunder. Even after the Supreme Court's decision in *Central Bank,* the implied right of action under Section 10(b) remains a broad remedy for investors injured by fraud or manipulation. The Supreme Court has recognized that these rights of action against primary violators are very significant and can reach beyond issuers to others who participate in a fraud.[29] We would anticipate that plaintiffs will push theories of direct liability more vigorously in light of *Central Bank.*

Moreover, the Exchange Act contains an express form of secondary liability that will continue to be available to Section 10(b) claimants. Section 20(a) of the Exchange Act, like Section 15 of the Securities Act, imposes liability on persons who control those who directly violate the Act. To escape liability under Section 20(a), a controlling person must show that he acted in good faith and did not directly or indirectly induce the violation.

Finally, of course, defrauded investors may have rights under State Blue Sky laws or other State laws. With respect to broker-dealers, these claims can be pursued in State actions or, where an investor has signed an arbitration agreement, in arbitration proceedings.

III. Conclusion

SIA understands the concern of the Subcommittee about the effect of the Supreme Court's decision in *Central Bank.* SIA believes in strong investor protections and adequate remedies for genuinely defrauded investors. At the same time, Congress should also consider other important factors. Those factors include the need to encourage capital formation and the existence of other broad investor protections. Accordingly, Congress ought not to try a "quick fix" by amending the Exchange Act to add a private cause of action for aiding and abetting. Instead, Congress should continue its examination, at the same time addressing the broader problems of securities litigation.

STATEMENT OF HARVEY J. GOLDSCHMID

DWIGHT PROFESSOR OF LAW, COLUMBIA UNIVERSITY SCHOOL OF LAW

Thank you Senator Dodd and Members of the Subcommittee for inviting me to testify today. My name is Harvey J. Goldschmid. I am Dwight Professor of Law at the Columbia University School of Law and specialize in corporate law, securities law, and antitrust. I am also Chair of the Committee on Securities Regulation of the Association of the Bar of the City of New York, and in that capacity, was Counsel of Record on the Association of the Bar's *amicus* brief in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*[1] *The Association of the Bar concluded that the "preservation of the civil remedy for persons damaged by those who aid and abet a securities fraud is essential to the effectiveness of the Federal securities laws."*[2]

Although I want to emphasize at the outset of my testimony that I am speaking for neither Columbia nor the Association of the Bar today, the words "essential to the effectiveness of the Federal securities laws" were—and are—not hyperbole. If the holding of the Supreme Court's 5–4 majority in the *Central Bank of Denver* case is not legislatively overruled, we face either a serious undermining of the integrity of our securities markets or years of confusion, unfairness, and unnecessary litiga-

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[28] Added by the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100–704, 102 Stat. 4677.

[29] *See* 62 U.S.L.W. at 4238.

[1] 1994 WL 132212 (U.S. Colo.)

[2] Brief *Amicus Curiae* of the Association of the Bar, p. 20.

tion while the word "indirectly" in Section 10(b) is read broadly enough to fill most of the gap that the Supreme Court's unfortunate holding has created.

The academic in me is tempted to spend time on a critique of the majority opinion in the *Central Bank of Denver* case. The majority opinion is in fact rigid and unwise—both in jurisprudential and policy terms—but your invitation properly focused us not on the opinion but on the key policy issue for the future: "[W]hether imposing private civil liability on aiders and abettors is good policy"? My answer to your question is emphatically "yes."

I will first address policy issues and then present my recommendations for ways in which Congress should respond to the *Central Bank of Denver* case. The policy positions I am taking are drawn largely (in words and spirit) from the Association of the Bar's *amicus* brief. The recommendations for how Congress should respond come solely from me.

Policy Considerations

Prior to the Supreme Court's decision in *Central Bank of Denver,* since 1939, in enforcement actions by the SEC, and at least since 1966, in private actions under Section 10(b), aiding and abetting liability had been universally accepted by the lower Federal courts. As Justice Stevens said in dissent in the *Central Bank of Denver* case:

> In hundreds of judicial and administrative proceedings in every circuit in the Federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b–5.[3]

The lower Federal courts have understood that aiding and abetting civil liability was required to impose an appropriate standard of diligence and care on professionals such as attorneys and accountants, without whose assistance many financial frauds could not be perpetrated. Investors in publicly traded securities often rely on professionals when evaluating investments. These professionals, whether attorneys, accountants, appraisers, engineers, or geologists, act as "gatekeepers," who provide assurance to the public investor of the financial integrity of investments.

Recent scandals on Wall Street, in corporate disclosure documents, and in the savings and loan industry emphasize how important it is for these "gatekeeping" roles to be played vigorously. But, in this regard, the Supreme Court's *Central Bank of Denver* holding provides precisely the wrong message. Without aiding and abetting civil liability, many of these gatekeepers, on whose credibility both buyers and sellers of securities depend, may be essentially immune from liability. More important, they may be free of the incremental spur to vigilance—the critical deterrent effect—that many need. As Judge Henry Friendly observed with characteristic insight, in upholding the criminal conviction of a lawyer who violated Section 17(a) of the Securities Act of 1933 (a Section which closely parallels the language of Rule 10b–5):

> [I]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. . . . Congress . . . could not have intended that men holding themselves out as members of these ancient professions should be able to escape . . . liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not posses.[4]

The SEC has accurately explained the special role of securities attorneys. The "task of enforcing the securities laws," the SEC opined, "rests in overwhelming measure on the bar's shoulders."[5] This is because of the unique role of the securities lawyer in the preparation of documents that are required to market securities to the public: "Very little of a securities lawyer's work is adversary in character. He doesn't work in courtrooms where the pressure of vigilant adversaries and alert judges checks him. He works in his office where he prepares prospectuses, proxy statements, opinions of counsel, and other documents that we [at the SEC], our staff, the financial community, and the investing public must take on faith. This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents that they produce."[6]

In this regard, I state with great pride, that the Association of the Bar was willing to step up and assume appropriate responsibility. In its *amicus* brief, at the end of its Summary of Argument, the Association of the Bar concluded:

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[3] 1994 WL 132212, 17 (U.S. Colo.)

[4] *United States* v. *Benjamin,* 328 F.2d 854, 863 (2d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[5] *In re Emanuel Fields,* 45 S.E.C. 262, 266 n.20 (1973), *aff'd without opinion,* 495 F.2d 1075 (D.C. Cir. 1974).

[6] *Id.*

As an organization of attorneys, the Association of the Bar is, of course, sensitive to the issue of lawyers' exposure to large damage claims. But it is also concerned about creating proper incentives for professionals and other persons involved in securities markets and it is particularly concerned with maintaining the integrity of the Bar. A system that creates proper incentives for securities lawyers to exercise due care—and avoid recklessness or intentional misconduct—in securities transactions serves the interest of attorneys who are committed to performing their responsibilities in a professional and ethical manner, as well as the interest of their clients and those who rely on their clients. The Association of the Bar believes that securities lawyers, like accountants and other professionals, are fundamentally important to the process of offering and trading securities in impersonal complex markets. Public confidence in such professionals is essential to a sound securities market system. Enforcement of the securities laws against transgressor professionals thus both serves the public and the best interest of the Bar.[7]

Two Possible Mitigating Open Issues

The Supreme Court's majority opinion in the *Central Bank of Denver* case left open two basic issues that could mitigate the harm caused by its decision. First, whether the SEC will be able to continue to have the power to impose civil liability for aiding and abetting under Section 10(b).[8] Second, whether the phrase "directly or indirectly" in the text of Section 10(b) can be read broadly enough to cover most of those who have heretofore been charged with aiding and abetting. I have very little hope that the first question will be answered affirmatively. I am more optimistic about the potential reach of "indirectly," but it will—at best—take years of confusing and wasteful litigation before the word "indirectly" captures much of the ground that should never have been lost.

The majority opinion's emphasis on the text of Section 10(b) leads me to doubt that the SEC will be permitted to impose civil aiding and abetting liability in the future. The majority concluded: "the text of the 1934 Act does not itself reach those who aid and abet a § 10(b) violation. . . . [W]e think that conclusion resolves the case."[9] Unless changes in the composition of the Supreme Court create a new majority and a new approach, I see no principled basis for giving the SEC a cause of action not available to private plaintiffs and not found in the statutory text. As Justice Stevens put it for the dissent: "The majority leaves little doubt that the Exchange Act does not even permit the Commission to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b–5."[10]

The language of Section 10(b) encompasses "any person" who "directly or indirectly" uses "any manipulate or deceptive device or contrivance." At least some of those who have heretofore been sued for aiding and abetting (*e.g.* accountants signing financial statements incorporated in disclosure documents, lawyers drafting disclosure documents) should be reachable as primary violators. The majority opinion acknowledged:

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming all of the requirements for primary liability under Rule 10b–5 are met.[11]

But the majority opinion also states that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abet-

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[7] Brief *Amicus Curiae* of the Association of the Bar, p. 4. The *amicus* brief (p. 2) describes the Association of the Bar as:

> A professional organization of approximately 19,000 lawyers, located largely in New York City but including members located throughout the United States and in over forty other countries. . . . As a bar group located in New York City, however, the Association of the Bar has a special interest in securities related issues. Since the Association of the Bar's founding, New York City has been the center of the Nation's capital markets, and particularly its securities markets. . . . A large percentage of the Nation's lawyers who specialize in the practice of securities law are members of the Association of the Bar. Accordingly, the Association of the Bar has both special expertise and a special interest in the important issues of securities law that are presented in . . . [the *Central Bank of Denver*] case.

[8] The Supreme Court acknowledge that criminal aiding and abetting liability is available to the Government under 18 U.S.C. § 2. *See* 1994 WL 132212, 16 (U.S. Colo.).

[9] 1994 WL 132212, 9 (U.S. Colo.)

[10] *Id.* at 19.

[11] *Id.* at 17.

ting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do."[12]

Academics will have great fun dealing with the majority's distinction in the classroom. Has an outside lawyer who knows of a CEO's financial wrongdoing and a corporation's related materially misleading disclosure documents, but fails to warn the board of directors or to attempt to stop the misleading disclosure, been "indirectly" involved in a proscribed activity, or has he or she merely given legally permissible "aid" to those who violated Section 10(b)? For the bar and litigants in general—and most notably for already overburdened lower court Federal judges—the majority opinion has created a litigation morass. The confusion created comes with a special lack of grace from a majority opinion that touted clarity, certainty, and predictability as policy values supporting its holdings.[13]

Recommendations

1. For the reasons stated, Congress should—as expeditiously as practicable—legislatively overrule the *Central Bank of Denver* case and make aiding and abetting claims available to both the SEC and private plaintiffs under the Federal securities laws.

2. Aiding and abetting should be defined in traditional terms as involving (i) a primary violation of the securities laws, (ii) knowledge of (or recklessness with respect to) the primary violation, and (iii) substantial assistance. Although not a mandatory part of legislation, I would suggest that Congress define—in general terms—the phrase "substantial assistance." The definition and legislative elaboration will be easy to articulate when active significant assistance is under consideration, but subtle issues arise when dealing with silence or inaction. I tentatively suggest that when silence or inaction is involved it should be vulnerable only when there is "either a duty to act or a conscious intent to assist the wrongful act."[14] The basic idea is that the substantial assistance requirement should not make vulnerable professionals whose connection with the transaction is remote or insignificant. As Professor Melvin A. Eisenberg jokingly put it, "knowingly bringing in coffee and sandwiches is not enough"[15] to create aiding and abetting liability.

3. New litigation should also reaffirm, what every lower Federal court to deal with the issue has held, that recklessness is the culpability standard under Section 10(b). This is an issue left unresolved by the Supreme Court in *Ernst & Ernst* v. *Hochfelder*,[16] in 1976, and in my view, is by far the most significant issue that has not been definitively resolved by the Supreme Court under the Federal securities laws. The issue was presented in the context of aiding and abetting in the *Central Bank of Denver* case, but was left unaddressed when the majority opinion held that there was no cause of action. A Supreme Court holding that only willful or intentional conduct violates Section 10(b) would have a potentially devastating effect on director, officer, and professional behavior; the soundness of both our disclosure system and securities markets would be gravely endangered. Directors, lawyers, accountants, and many others, would have powerful legal incentives to simply ignore red flags suggesting fraud or egregious disclosure failures. Only actual intent would make them vulnerable. After the majority opinion in the *Central Bank of Denver* case, this Subcommittee and Congress could perform no greater service to the Nation, in the business law area, than confirming the applicability of a recklessness standard under Section 10(b).

4. Finally, new legislation could include balanced litigation reforms and other procedural and substantive provisions.[17] My basic qualification with respect to broad new legislation is that it not significantly delay Congress from reimposing aiding and abetting civil liability and from confirming that recklessness is the appropriate standard upon which to predicate liability under Section 10(b) and Rule 10b–5.

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[12] *Id.* at 7.

[13] *Id.* at 15–16.

[14] W. Cary & M. Eisenberg, *Cases and Materials on Corporations* 886 (6th ed. 1988); for a very useful discussion of aiding and abetting case law, *see* 9 9 L. Loss & J. Seligman, *Securities Regulation* 4479–88 (3d ed. 1992).

[15] *Id.* at 885.

[16] 425 U.S. 185 (1976)

[17] My suggested procedural and substantive reforms are discussed in H. Goldschmid, *Securities Regulation, in* M. Green (ed.), *Changing America: Blueprints for the New Administration* 616–30 (1992).

STATEMENT OF EUGENE I. GOLDMAN

PARTNER, MCDERMOTT, WILL & EMERY

Mr. Chairman and Members of the Subcommittee, I would like to thank you for this opportunity to testify on the impact of the Supreme Court's decision in *Central Bank of Denver* v. *First Interstate Bank* and what, if any, potential legislative remedies might be appropriate in response to the decision. My name is Eugene Goldman and I am a partner in the Washington, DC office of McDermott, Will & Emery, a full-service national law firm with approximately 500 attorneys.[1] I represent clients before the SEC's Division of Enforcement and in private securities litigation, including class action suits. I previously served 6 years as an attorney and Senior Counsel in the SEC's Division of Enforcement. Mr. Chairman, I want to commend you for your continued leadership and interest in the area of securities law reform, and I know I am speaking for many in the securities bar in so commending you.

Mr. Chairman, I view the Supreme Court's decision in Central Bank as presenting the Congress with the opportunity to examine the whole issue of varying levels of liability for defendants in securities law suits. As the Supreme Court recognized, the rules for determining aiding and abetting liability have been unclear and have exacted costs via vexatious litigation that disserve the goals of fair dealing and efficiency in the securities markets. In this connection, I believe that there is ample logic for the Congress to consider certain provisions of the proposed Private Securities Litigation Reform Act (S. 1976) at the same time it considers whether legislation is necessary in response to the *Central Bank* case. I would like to address the relevance of S. 1976 to the issue at hand as well as the following three issues. First, does *Central Bank* apply to SEC actions which seek to impose aiding and abetting liability? Second, is it essential that the SEC be expressly authorized at this time to bring actions for aiding and abetting violations? Third, if Congress decides to add specific statutory language authorizing aiding and abetting claims in private suits, should it also express the prerequisites for imposing liability and, if so, what should the standard be?

The Central Bank Decision Applies to SEC Actions

The dissent's concern in *Central Bank* that the majority's decision may preclude the SEC from pursuing aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b–5, *see Central Bank,* 1994 U.S. LEXIS 3120, at 65–66, is well-founded. The majority relied primarily on the statutory text of § 10(b) and Rule 10b–5 in holding that a private plaintiff may not maintain a cause of action for aiding and abetting under those provisions. In other cases in which it has relied on the statutory text to determine the scope of § 10(b) and Rule 10b–5, the Court has found no reason not to extend its holding both to cases in which the SEC is a plaintiff and in which a private party is the plaintiff.

For example, in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 193 (1976), the Court held that a private plaintiff could not maintain an action for civil damages under § 10(b) and Rule 10b–5 absent an allegation of scienter. In so holding, the Court relied primarily on the statutory language of § 10(b) and Rule 10b–5. The Court expressly reserved the question of whether scienter also was a necessary element in an action by the SEC for injunctive relief under § 10(b) and Rule 10b–5. *Ernst & Ernst,* 425 U.S. at 193 n.12.

The Court reached this reserved question in *Aaron* v. *SEC,* 446 U.S. 680, 695 (1980). In *Aaron,* the Court held that

> The rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b–5, regardless of the identity of the plaintiff or the nature of the relief sought. Two of the three factors relied upon in *Hochfelder*—the language of § 10(b) and its legislative history—are applicable whenever a violation of § 10(b) or Rule 10b–5 is alleged, whether in a private cause of action for damages or in a Commission injunctive action . . .

Aaron, 446 U.S. at 691. Thus, the Court's interpretation of the statutory language of § 10(b) and Rule 10b–5 was not in any way affected by whether the plaintiff was the SEC or a private party.

Similarly, nothing in the majority's rationale in Central Bank restricts to private actions the Court's decision that § 10(b) and Rule 10b–5 do not give rise to a private cause of action for aider and abettor liability. The Court clearly has interpreted the text of these provisions as applying equally to public and private plaintiffs. Thus, there is no reason why the majority's holding in *Central Bank* that § 10(b) and Rule

[1] This statement reflects the views of Eugene I. Goldman and does not necessarily reflect the views of McDermott, Will & Emery or any of its clients.

10b–5 do not give rise to a cause of action for aider and abettor liability should not equally apply to cases in which the plaintiff is the SEC.

Notwithstanding initial pronouncements from the SEC staff that the *Central Bank* decision does not apply to SEC actions, it appears that, upon reflection, the SEC now recognizes that this decision does serve to restrict its authority to bring implied aiding and abetting claims under § 10(b) and Rule 10b–5. Several defense attorneys with matters pending before the enforcement division have recently received communications in which the SEC staff, on its own initiative, advised that it is dropping aiding and abetting charges. For example, I was advised that aiding and abetting claims under provisions other than § 10(b) would be dropped from a proceeding to be brought against a client. This suggests that the SEC recognizes that, under a plain reading of *Central Bank's* ruling that the scope of a statute should be determined by what is expressed in the statute, there is no more basis for making aiding and abetting claims under other securities law provisions that lack express aiding and abetting language than there was for making aiding and abetting claims under § 10(b).

It Is Not Essential at This Time to Provide the SEC With Express Authority to Bring Aiding and Abetting Claims

I believe that it remains to be seen whether a legislative overruling of *Central Bank* is essential as it relates to the SEC. While the SEC's briefs in *Central Bank* assert that approximately 15 percent of the agency's enforcement cases have an aiding and abetting element, no disclosure has been made of the number of cases where aiding and abetting is the only hook to the defendant.

In other words, the SEC has not broken out the 15 percent into the level of cases in which aiding and abetting is thrown in with allegations of primary violations and the level of cases which are entirely aiding and abetting.

More importantly, the SEC has authority under Section 21C(a) of the Exchange Act to obtain cease and desist orders. These orders can be obtained against persons who cause a securities law violation, even if the persons are neither direct violators nor aiders and abettors as long as they "should have known" that an act or omission would contribute to such violation. The SEC, by employing this negligence-sounding standard, can stop violators in their tracks via the cease and desist proceeding and the airing of such charges.

It therefore has not been established that elimination of aiding and abetting liability would significantly diminish the effectiveness of Commission actions to protect the investing public.

Legislation Authorizing Aiding-and-Abetting Liability Should Express the Standard for Satisfying the Scienter Requirement

In the event the Congress determines to authorize aiding and abetting claims expressly, it should also consider establishing statutory prerequisites for imposing such liability.

Such an expressed standard would obviously facilitate uniform judicial treatment of those who have not allegedly committed a manipulative or repetitive act but only allegedly aided and abetted the violation. I have been concerned for some time that the "recklessness" standard employed by different courts is arbitrary, borders too closely on concepts of negligence, jeopardizes participants in routine business transactions, and ignores the presence or absence of a duty of disclosure.

In addition, the Court's discussion in *Central Bank* of the "critical" prerequisite of reliance is highly relevant but has been somewhat ignored in the comments following the decision. The Court, citing *Basic Inc.* v. *Levinson,* made it clear that a defendant cannot be liable as an aider and abettor under 10b–5 without a "showing that the plaintiff relied upon the aider and abettor's statements or actions." A specific standard for imposing aiding and abetting liability should include a reliance requirement.

Mr. Chairman, in the event Congress decides to establish a specific standard for imposing liability, I am sure that there will be no shortage of volunteers to draft a proposed standard requiring a showing of some actual knowledge of the primary violation, reliance and consideration of whether the defendant owed a duty of disclosure to the plaintiff.

If Congress Further Considers a Legislative Response to *Central Bank*, Certain Provisions of S. 1976 Should Also Be Considered

Mr. Chairman, the legislation which you and Senator Domenici introduced, the Private Securities Litigation Reform Act of 1994, contains certain provisions which are highly relevant to any consideration of whether the impact of *Central Bank* warrants a legislative response. As the Court in *Central Bank* recognized, "entities subject to secondary liability as aiders and abettors may find it prudent and necessary,

as a business investment, to abandon substantive defenses and to pay settlements in order to avoid the expense and risk of going to trial."

Mr. Chairman, that risk will remain very real if no regard is given to the degree of liability of each party or to a just proportion of the damages to be paid. I therefore recommend that the proportionate liability section of S. 1976 (Section 203) be factored into the equation when considering a legislative response to *Central Bank*. That way, the nature and conduct of each defendant and the causal relationship between the conduct and plaintiff's damages will be recognized if aiding and abetting claims are permitted in the future. In addition to Section 203, I submit that Section 104 of S. 1976 is quite relevant to today's discussion because its purpose is to screen out at the pleading stage allegations that have no factual basis and compel greater clarity about the claims and issues in multiple defendant cases.

I thank the Chairman and Members of the Subcommittee for your consideration of my remarks.

TESTIMONY OF DAVID S. RUDER [1]

Introduction

It gives me great pleasure to appear before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs in order to present my views on the question raised by the Supreme Court's decision in *Central Bank of Denver* v. *First Interstate Bank of Denver*,[2] namely whether Congress should enact legislation making it unlawful to aid or abet a violation of the Federal securities laws and if so, what should be the content of that legislation.

In general, a person will be an aider and abettor of a securities law violation if:

1. A third party violates the Federal securities laws;
2. The person knows that the primary violation is taking place; and
3. The person provides substantial assistance to the wrongdoer in achieving the primary violation.

Until the *Central Bank of Denver* case, aiding and abetting theory was utilized by both the SEC and private plaintiffs against persons who knowingly provided assistance to primary wrongdoers in securities frauds. I believe Congress should enact legislation restoring aiding and abetting as an unlawful activity under Section 10(b) of the Securities and Exchange Act of 1934 in order to restore that theory for use by both private plaintiffs and the SEC. The legislation or legislative history should make clear that the aiding and abetting provisions of Section 10(b) and the controlling person provisions of Section 15 of the Securities Act of 1933 (the 1933 Act) and Section 20(a) of the Securities Exchange Act of 1934 (the 1934 Act) provide the exclusive remedies against persons other than primary participants. Most importantly, Congress should continue to explore ways of dealing fairly with problems stemming from large damages in securities law class actions.

Analysis

The 1933 and 1934 Acts are the primary Federal securities laws dealing with fraud in the purchase and sale of securities, and include a series of provisions designed to prevent fraud. Some of these provisions provide express private rights of action to persons injured by securities fraud, and some of those provisions do not, apparently limiting the use of those sections to administrative actions by the Securities and Exchange Commission (SEC) and to criminal prosecutions.

Section 10(b) of the 1934 Act, which does not provide an express private right of action, states that it shall be unlawful for any person to purchase or sell securities by use of a "manipulative or deceptive device or contrivance." In 1942, pursuant to its Section 10(b) powers, the SEC adopted Rule 10b–5, which makes it unlawful, in connection with the purchase or sale of any security, for any person:

1. To employ any device, scheme, or artifice to defraud;

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[1] Professor of Law, Northwestern University School of Law. Partner, Baker & McKenzie. Chairman, U.S. Securities & Exchange Commission 1987–1989. The author has written several law review articles relevant to this testimony: (1) "Civil Liability Under Rule 10b–5: Judicial Revision of Legislative Intent?" 57 Nw. U.L. Rev. 185 (1964) (arguing that since no positive legislative intent exists, no private action should exist under Rule 10b–5); (2) "Gulf Texas Sulphur—The Second Round: Privity and State of Mind in Rule 10b–5 Purchase and Sale Cases," 63 Nw. U.L. Rev. 423 (1968) (arguing that culpability should be the primary means of determining securities law liability); (3) "Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, *In Pari Delicto*, Indemnification and Contribution," 120 U.Pa.L. Rev. 597 (1972) (reviewing the law of aiding and abetting liability and arguing for a knowledge standard).

[2] 62 U.S.L.W. 4238 (1994) (the *Central Bank* case).

2. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

3. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

In a series of cases, the Federal courts have held that despite the lack of an express private remedy based upon Section 10(b), persons injured by those violating Rule 10b–5 can bring private actions to recover damages. Due to the broad language contained in Rule 10b–5, the Rule has provided Federal courts with the opportunity to fashion the details of the law of securities fraud. As a result, Rule 10b–5 has become the primary means by which injured persons and the SEC are able to recover from and otherwise punish those who have engaged in securities fraud. Rule 10b–5 is the primary basis for doctrines dealing with insider trading, misrepresentations to purchasers and sellers of securities, market manipulation, and broker dealer obligations to customers.

In effect, Congress has allowed the Federal judiciary to develop a Federal law of securities fraud in a gradual manner. Although it is not easy to demonstrate Congressional legislative intent that the Federal courts should develop the Rule 10b–5 jurisprudence in all of its detail, the overall results have been salutary.

For private plaintiffs, two developments have made Rule 10b–5 a powerful weapon for addressing securities fraud. First, numerous Federal courts have held that a contractual relationship between the injured buyer or seller of securities and the wrongdoer is not required. Thus a person or corporation making a public misstatement or engaging in other wrongdoing may become liable to an investor buying or selling securities even though the person did not sell or purchase securities and thus was not in "privity of contract" with the wrongdoer.

Second, the Federal Rules of Civil Procedure make it possible for a single representative plaintiff to represent all persons similarly situated in a single class action law suit. This ability to add the injuries of all similarly situated parties into a single suit against securities law violators has created the possibility of law suits claiming enormous damages. For instance, a corporation making a misstatement causing its shares to be valued at $20 over its real market value might find itself subject to claims by purchasers of 10 million shares for damages per share of $10 per share, or a total of $100 million. Those aiding and abetting the corporate wrongdoer might also be joined as defendants and be subject to large liability awards.

As the development of a Rule 10b–5 has continued, a series of Supreme Court cases have provided some restrictions on its use. Most important, in 1976, the Supreme Court held that a showing of scienter is required in order to prove a Rule 10b–5 violation.[3] Relying upon the language "manipulative or deceptive," which appears in Section 10(b), the court held that negligence was not sufficient to prove a Rule 10b–5 violation. It indicated that the appropriate standard was "intent to deceive or defraud," but did not further define that phrase except to say that "knowledge" would be sufficient. Although it left open the question whether recklessness would be sufficient to meet the Rule 10b–5 *scienter* test, most Federal circuit courts of appeals have embraced the recklessness standard as sufficient to meet the Rule 10b–5 *scienter* test.

Aiding and abetting as a doctrine under Rule 10b–5 had its beginnings in 1966, when an Indiana Federal district court[4] held that an insurance company had aided and abetted a scheme by a securities broker who was defrauding customers by taking orders for securities of the insurance company, failing to purchase the securities, and nevertheless accepting payment for the securities. The insurance company was held to have aided and abetted the scheme by passing customer complaints to the securities broker, thereby enabling the broker to cover up his activities by delivering securities to the complaining customers (but not to others). Subsequently, all eleven Federal circuit courts of appeal have affirmed the existence of aiding and abetting liability under Rule 10b–5.[5] In most of those cases, accountants, lawyers, banks, corporations, and others have been held to have violated the Federal securities laws by aiding wrongdoers with knowledge of the wrongdoing.

As noted above, many aiding and abetting lawsuits are class actions under Rule 10b–5 seeking large damages on behalf of large numbers of injured purchasers or sellers of securities from defendants who have neither bought nor sold securities. Most typically the aiding and abetting defendants in these cases are accountants, lawyers, and banks whose roles have been secondary. Under the doctrine of "joint

[3] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

[4] *Brennan* v. *Midwestern Life Ins. Co.*, 259 F.Supp. 673 (N.D. Ind. 1966), aff'd, 417 F.2d 147 (7th Cir. 1969).

[5] *Central Bank of Denver*, dissent, 62 L.W. at 4238.

and several" liability, these aiders and abettors have became subject to all of the liability that could be imposed upon the primary wrongdoers.

The threat that the secondary defendants can become liable for all of the damage caused by the primary wrongdoers has had a dramatic effect upon settlement negotiations in large class action suits. Large class actions frequently have been settled by secondary defendants for significant sums because of the possibility that they will be required to pay the entire amount claimed. In the absence of Congressional action, the holding in the *Central Bank of Denver* case that aiding and abetting actions cannot be brought under Rule 10b–5 will help to alleviate some of the problems associated with large damage claims, but the problems will not go away. Plaintiffs in the large damage cases will undoubtedly allege that accountants, lawyers, banks, and others now included as secondary defendants were primary participants in a scheme to defraud. The settlement bargaining process will continue, and the secondary defendants, now to be called "primary participants," will continue to be under enormous pressure to settle.[6]

Recognition that the holding in the *Central Bank of Denver* case assists defendants in large damage claim class actions, but does not solve the problems inherent in the bargaining process, leaves Congress with a complicated set of solutions.

1. Should it do nothing, and allow Federal securities fraud law under Rule 10b–5 to develop without an aiding and abetting theory?
2. Should it merely overturn the *Central Bank of Denver* case, leaving the courts to continue the development of the law of aiding and abetting?
3. Should it overturn the *Central Bank of Denver* case, but provide guidance regarding development of the aiding and abetting doctrine?
4. Should it undertake a thorough review of the Federal law of securities fraud?[7]

The choice of solutions should be made against a background of understanding regarding interpretations of the aiding and abetting doctrine under Rule 10b–5 prior to the *Central Bank of Denver* case.

Under the aiding and abetting doctrine as interpreted by the Federal courts prior to the *Central Bank of Denver* case, two important inquiries were of central importance in determining outcome:

1. What degree of knowledge is required?; and
2. What degree of action is required?

In the typical case, the primary fraud had been carried out by another person. As noted earlier, the aider and abettor would not have been a primary participant in the fraud, but would have engaged in an activity which assisted the primary wrongdoer. For instance, the accountant may have certified the financial statements of a company which later were shown to have contained false statements; the lawyer may have assisted in preparing disclosure documents which later were shown to have contained false statements; the bank may have loaned money to a person who used the money in fraudulent activities or may have delayed independent review of an appraisal which would have shown that property values were falsely stated. In each of these cases the secondary defendant would have engaged in a commercial transaction involving normal activities. The benefit received by the alleged aider and abettor would have been much less than that benefit to be received by the primary wrongdoer.

In examining the circumstances under which aiding and abetting liability should be imposed (assuming the existence of a securities violation by a primary wrongdoer), the courts have treated the subject matter with care. Although they usually have not articulated benefit theories, most courts have imposed aiding and abetting liability when the conduct of the secondary defendant involved one of the following circumstances: (a) Substantial assistance given with knowledge of the primary wrongdoing. (b) Knowledge and inaction coupled with a conscious intent to assist the primary violator.

Prior to the *Central Bank of Denver* case, some areas of doubt in interpreting the aiding and abetting still existed.[8] For instance,

1. Some courts articulated the standard for liability as "a general awareness" of improper activity, plus knowing and substantial assistance;

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[6] The SEC also can be expected to pursue defendants as primary participants.

[7] If it follows this course Congress should refer to the proposed "Federal Securities Code" (American Law Institute, 1980). The author served as Consultant to the Reporter for Part XVI, "Fraud, Misrepresentation, and Manipulation" and Part XVII, "Civil Liability."

[8] *First Interstate Bank of Denver* v. *Pring*, 969 F.2d 891 (1992), the case reversed by the *Central Bank of Denver* case, contains a good description of differences in approach.

2. Some courts held that there could be no aiding and abetting liability for inaction, absent a duty to disclose.

3. Recklessness was considered by some courts as satisfying both the Rule 10b–5 *scienter* requirement and the aiding and abetting knowledge requirement.

Conclusion

The process of interpretation of the law of aiding and abetting by the Federal courts is consistent with the historical role of those courts in fashioning remedies for fraud under Rule 10b–5. What is emerging under aiding and abetting law as interpreted by the Federal circuit courts is an analysis based upon intent, recklessness, and fiduciary duty. This analysis is soundly based in terms of human conduct and Congress would not be remiss in merely passing legislation saying in effect that aiding and abetting is actionable under Section 10(b) of the 1934 Act.

In reversing *Central Bank of Denver,* Congress should be aware that the Supreme Court may not agree with the Federal circuit courts in their interpretations of the aiding and abetting doctrine. If the Congress provides no guidance, then some of the *dicta* in the Court's *Central Bank of Denver* opinion will become important. Although the Court in that case acknowledged SEC arguments that "the aiding and abetting cause of action deters secondary actors from contributing to fraudulent activity and ensures that defrauded plaintiffs are made whole,[9] it also offered statements indicating its dissatisfaction regarding the development of the aiding and abetting doctrine. For instance, it made the following statements:

"Secondary liability for aiders and abettors exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets."[10]

"Because of the uncertainty of the governing rules, entities subject to secondary liability as aiders and abettors may find it prudent and necessary, as a business judgment, to abandon substantial defenses and to pay settlements in order to avoid the expense and risk of going to trial."[11]

"In addition, the increased costs incurred by professionals because of the litigation and settlement costs under 10b–5 may be passed on to their client companies, and, in turn incurred by the company's investors, the intended beneficiaries of the statute."[12]

Although these statements reflect policy view points, they indicate only that the Court is concerned, as is Congress, with problems related to large claim securities class actions. They may seem to predict a conservative approach to aiding and abetting liability, but no road map appears.

They do emphasize, however, that if Congress reverses the *Central Bank of Denver* case, it continues to bear a responsibility for examining the economic effects of imposing unlimited liability in class actions upon a group of secondary defendants who were not likely to benefit in a manner commensurate with their misconduct. The fees received by accountants, lawyers, and banks for their commercial services do not justify enormous dollar judgments against them in securities law class action cases. Congress should continue its efforts to examine means of limiting liability in securities law large damage cases.

In reversing the *Central Bank of Denver* case, Congress should also indicate in legislation or legislative history that the controlling persons provisions of the 1933 Act (Section 15) and the 1934 Act (Section 18(a)) and the new aiding and abetting provisions of Section 10(b) are intended as the exclusive methods of imposing liability on secondary defendants. Congress should do this because, in contrast to the now well defined doctrine of aiding and abetting, two other doctrines, conspiracy and *respondeat superior* do not have a long history of analysis by the Federal courts.[13]

The doctrine of conspiracy has not been well addressed by the courts because of the existence of well established aiding and abetting and controlling person theories. If aiding and abetting is actionable, no need exists for its application to the securities laws.

The doctrine of *respondeat superior* has been followed by some courts, but its development has been restricted to the broker-dealer field. *Respondeat superior* is a doctrine which imposes liability without regard to culpability. In view of the extensive legislative and jurisprudential attention to the doctrine of fault or culpability in the Federal securities laws, the doctrine of *respondeat superior* should not be ap-

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[9] *Central Bank of Denver,* 62 LW at 4237.

[10] *Id.*

[11] Id.

[12] Id.

[13] Despite the dissent's footnote addressing these remedies, *Id.* at 4240, judicial attention to them has been comparatively scant.

plicable under Rule 10b–5. If Congress wants to adopt a no fault liability provision for some selected groups, such as broker-dealers, it should do so expressly.

This testimony has advanced the premise that Congress may well wish to let the Federal courts establish the boundaries of securities law fraud actions under Rule 10b–5, reserving the ability to change the law where it disagrees with court interpretation. This approach, of course, means that Congress must continue to observe development of the law and to take necessary action to amend the law in appropriate circumstances.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM ARTHUR LEVITT

Q.1a. As your San Diego speech suggested, and as commentators have noted, aiding and abetting is used routinely as a boilerplate allegation to indiscriminately sweep into a case all kinds of peripheral defendants.

These defendants are then forced to hire lawyers, sit through depositions, and have their credit put on hold.

To make matters worse, because of the applicable standards, these peripheral defendants--no matter how innocent--typically cannot get out of these cases at the motion to dismiss stage or even at summary judgment.

They are forced to settle the case, rather than take the unacceptable risk of going to trial and losing a huge judgment. The strike suit lawyers know this: That is precisely why they include these peripheral defendants in their complaints.

Are there any safeguards against this type of abuse built into the Metzenbaum approach?

A.1a. Although it is difficult to estimate the extent to which meritless securities cases are filed in the hope of extracting a settlement, a litigation system imposes tremendous unnecessary costs when it is abused by investors or their attorneys. Our challenge is to find ways to minimize its costs while preserving the rights of defrauded investors. I have voiced my concerns about such abuses and have endorsed a number of legislative measures designed to deter frivolous litigation without having an adverse effect on meritorious cases. It is important to distinguish, however, between legislation directed at correcting abusive litigation practices, which are by no means confined to aiding and abetting claims, and legislation that would restore liability for persons who knowingly or recklessly provide substantial assistance to a violation of the securities laws.

In the Commission's judgment, the <u>Central Bank of Denver</u> decision fundamentally curtailed well-established investor rights without regard to the merits of particular cases. As I testified last month, appropriate legislation should include provisions to the effect that the Commission can seek injunctions and other relief against aiders and abettors (eliminating current uncertainty in this regard) and to restore aiding and abetting liability in private actions.

The approach taken in a draft amendment to S.1963, prepared by Senator Metzenbaum but not yet introduced, would amend Section 10 of the Securities Exchange Act of 1934 to make explicit the right of a private person to bring an action under that section and to make it expressly unlawful to "aid and abet" the use or employ of a manipulative or deceptive device or contrivance. The draft amendment would also amend Section 21(d)(1) of the Exchange Act to clarify the Commission's authority to seek remedies under that section against persons who aid, abet, counsel, command, induce or procure securities law violations.

The draft amendment, by simply restoring a right of action against persons who aid and abet a securities law violation, does not purport to address the issue of frivolous litigation. Aiding and abetting claims made under the draft language, like aiding and abetting claims made prior to Central Bank, would be subject to existing safeguards against abuse such as Federal Rule of Civil Procedure 9(b), which permits dismissal of a complaint which is not pleaded with particularity, and Federal Rule of Civil Procedure 11, which authorizes sanctions for filing a complaint in bad faith.

Q.1b. Senator Dodd asked the SEC to provide suggested language to reinstate aiding and abetting liability. How would the SEC proposal prevent the abuse of this theory by lawyers attempting to extort settlements?

A.1b. Securities frauds can involve a wide range of wrongdoing, including insider trading, fraudulent financial disclosures, and market manipulations. In order to reach the far boundaries of these frauds, statutory language restoring aiding and abetting liability should be broadly drafted. In my judgment, it would be a mistake to constrict the fundamental scope of the statute sharply in order to reduce meritless securities litigation. Instead, meritless litigation should be addressed through carefully crafted procedural and pleading requirements, sanctions, and other measures which are focused directly on frivolous litigation.

Q.1c. What safeguards should be included to stop meritless cases from being filed against deep pocket defendants for the sole purpose of forcing a settlement?

A.1c. In addition to existing safeguards such as Rule 9(b) and Rule 11, I would urge the Subcommittee to consider the various measures endorsed by the Commission in its testimony before the Subcommittee at the hearing on "Private Litigation Under the Securities Laws" on June 17,

1993, as well as the measures I mentioned in my speech in January before the Securities Regulation Institute and the other approaches currently being developed. These measures include limited fee shifting for cases brought without any substantial basis in fact or law, measures to prevent the use of professional plaintiffs in securities class actions, and related proposals directed specifically at litigation abuses.

Q.2a. How will securities law enforcement change if Bank of Denver is allowed to stand?

A.2a. As I discussed in my testimony, the Commission's preliminary assessment is that its enforcement program can continue to operate effectively. Certain adjustments will, of course, be necessary. For example, it is likely that the Commission will bring more cases under its administrative authority, which does not provide for civil money penalties against non-regulated entities.

The effect of Central Bank on private enforcement of the securities laws is more direct. Unlike the Commission, private litigants do not have clear alternative approaches to reach aiders and abettors under the federal securities laws. The Commission has long maintained that private actions under the federal securities laws are a necessary supplement to the Commission's own enforcement efforts in ensuring wide-spread compliance with the securities laws. As the Commission's unsuccessful brief before the Supreme Court in Central Bank stated, "[t]he private right of action's effectiveness as a supplement to Commission enforcement would be severely undercut if it did not also reach aiders and abettors." I believe that the Supreme Court's decision could operate as a significant constraint on overall securities law enforcement.

Q.2b. What types of behavior would no longer be actionable?

A.2b. Unless another theory of liability can be applied in a particular case, it is no longer possible for private litigants to seek redress under the federal securities laws against those who knowingly or recklessly provide substantial assistance to another person's violation of the securities laws. Persons whose assistance or acquiescence may have been necessary to the fraud, or who may have been acting behind the scenes, but who did not themselves directly make statements that were relied upon by investors, may escape any liability to private parties.

Q.2c. Would there be more or fewer settlements?

A.2c. It seems likely that there will be somewhat fewer defendants named in private securities lawsuits since the Central Bank decision does away with claims against a whole class of defendants. It is not possible to predict whether the decision will have any effect on the number of securities cases which are settled rather than tried or dismissed.

Q.3. In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

A.3. The Court's discussion of these issues was in response to the argument that Congress must have intended that aiding and abetting be included in the proscriptions of Section 10(b), notwithstanding the absence of express language to that effect, because imposing such liability would effectuate the policies underlying the statute. The Court cited other arguments, such as those mentioned in this question, which could weigh against an imposition of aiding and abetting liability. The Court hastened to point out that competing policy arguments in favor of aiding and abetting liability could also be advanced, but noted that, "it is far from clear that Congress in 1934 would have decided that the statutory purposes would be furthered by the imposition of private aider and abettor liability."

The Court cited vexatiousness as an issue affecting litigation under Rule 10b-5 generally, not just aiding and abetting claims. I believe that legislation which is carefully crafted to address the problems of frivolous litigation, without adversely affecting the rights of defrauded investors to bring meritorious claims, would be both desirable and necessary to maintain the fairness and efficiency of our capital markets. Such legislation should not be confined to aiding and abetting claims.

If predictability is a problem with respect to claims of aiding and abetting, it is likely a result of such claims having been merely implied under Section 10(b) and Rule 10b-5. Legislation to restore aiding and abetting liability can, and should, resolve uncertainties, such as the degree of scienter required for liability, and thereby lead to greater predictability.

Q.4. The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued just because of fluctuation in

stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

A.4. New and small businesses, as well as any other sorts of businesses, should not be subjected to meritless lawsuits. Neither should persons providing professional services to such businesses. Carefully crafted legislation that addresses the problems of meritless litigation without adversely affecting the rights of defrauded investors to bring meritorious claims would be a positive step. In addition, the Commission staff is currently exploring potential ways in which safe harbors for forward-looking statements may be improved without impairing investor protection. This may help to alleviate some of the problems experienced by unseasoned companies. I believe it is vitally important, however, that professionals who knowingly or recklessly provide substantial assistance to another person's violation of the securities laws be held liable for their actions.

Q.5a. Senator Metzenbaum has proposed reinstating aiding and abetting liability.

How do you think the Supreme Court should interpret the Metzenbaum language recreating aiding and abetting liability?

A.5a. I believe that remedial statutes, such as Section 10(b) of the Exchange Act, should be read broadly to effectuate their remedial purposes: however, I recognize that this Supreme Court may be expected to construe strictly the words of a statute. In determining that Section 10(b) did not impose liability for aiding and abetting, the Court stated:

> "Congress knew how to impose aiding and abetting liability when it chose to do so. * * * If . . . Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' and 'abet' in the statutory text. It did not."

The amendment proposed by Senator Metzenbaum would make it unlawful to "aid and abet" the use or employ of any manipulative or deceptive device or contrivance. This language seems to comport with the Court's requirement for a clear indication of Congressional intent. As a matter of legislative drafting, however, it would be preferable to spell out in greater detail the various elements of aiding and abetting liability in order to clarify some of the questions left unresolved by the Central Bank decision.

Q.5b. Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions."?

A.5b. As I noted above, anti-fraud provisions must be sufficiently broad to ensure that all types of securities fraud are covered. I should also note that the uncertainties raised by securities fraud litigation usually involve the application of law to particular facts, as opposed to the substantive law itself. As pointed out by the four dissenting Justices in Central Bank, there were two areas of uncertainty with respect to the private right of action against aiders and abettors: whether aiding and abetting liability based upon a failure to act must be predicated upon an existing duty owed by the aider and abettor to the injured investor, and whether recklessness is sufficient for an imposition of liability. It would be desirable to include language in any proposed amendment to resolve these issues.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM

DONALD C. LANGEVOORT

Q.1. How will securities law enforcement change if *Bank of Denver* is allowed to stand? What types of behavior would no longer be actionable? Would there be more or fewer settlements?

A.1. Of course, one can only speculate about the future course of the law without aiding and abetting liability. Moreover, the pre-*Bank of Denver* law was in such a state of flux that it is difficult to predict its course even had private aiding and abetting liability not been eliminated. The trend in the law had been toward limiting its availability.

In the absence of legislation, I suspect that accountants would continue to face widespread liability as primary wrongdoers when they are knowingly or recklessly responsible for misinformation in the financial statements that they prepared or audited. This is the most common sort of claim against accountants. It is also possible that the courts will stake out a scope to primary liability that includes other persons who take some active role in the preparation of fraudulent misrepresentations or omissions, even if they are not the only (or even the dominant) participant in the disclosure process. If so, then lawyers and others who draft or advise in the preparation of fraudulent disclosure will still face liability, even without legislation.

On the other hand, it is possible that the courts will be more restrictive, imposing primary liability only when investors relied on the sorts of misstatements primarily attributable to the defendant itself. Then, those who help in the fraud -- but do not bear visible responsibility for it -- will avoid liability. The clearest constriction would be that those whose assistance has nothing to do with the disclosure process (for example, a bank that knowingly provides financing to a company that is fraudulently selling securities to the public) will be free from exposure. The loss to the enforcement process from any such narrowing arises because such persons or institutions are often in a position to withhold essential services from -- and thus thwart -- those about to commit securities fraud.

As I indicated in my testimony, there is a real possibility that *Bank of Denver* will be read to eliminate aiding and abetting in SEC enforcement actions. This would be quite serious. I believe that the threat of civil penalties, especially, is a stong deterrent to securities fraud, and should be available against those who knowingly aid a wrongdoer.

With respect to settlements, I am not entirely sure that there will be fewer (except to the extent that certain institutions who would have settled are not named as

defendants in litigation in the first place). On balance, however, they should be on terms more favorable to the defendants, to reflect the smaller risk of liability.

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Q.2. In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

A.2. With respect to predictability, there would be some virtue to a clearer definition of what is covered and what is not. A definition of aiding and abetting should make clear the appropriate state of mind requirement for liability -- the most uncertain issue under pre-*Central Bank* law. In my view, secondary liability should be imposed only if the defendant was actually aware of the wrongdoing or deliberately closed his or her eyes to it. Objective recklessness should not be a basis for liability.

The more severe problem is vexatiousness. This, of course, is an issue that goes well beyond aiding and abetting, and could not (and should not) be addressed only in that one context. I believe that the most useful step that can be taken is to authorize and require a court to hold a hearing at the ourset of all class actions in securities fraud cases to examine the evidentiary basis for plaintiffs' case and determine whether in fact it has sufficient merit -- i.e., creates a sufficiently strong inference that there was misconduct -- to warrant moving on to class certification and discovery. The SEC could well be given a role in such hearings. This sort of process would weed out meritless cases far more efficiently than those offered by the current set of preliminary motions (9(b) motions, motions for summary judgment, etc.). The process would have particular usefulness in the context of secondary liability because a court could dismiss an aiding and abetting claim against one or more defendants for lack of merit even if the underlying action against the primary wrongdoers was allowed to go forward.

In my view, the problem of predictability is merely the product of concern about vexatiousness. Were something to be done to remove much of the fear of meritless litigation, I suspect that the courts would gradually return to the standard framework for liability that had existed prior to the mid-1980's. Much of the "confusion" in the law is really the product of courts trying various means of cutting back on the availability of secondary liability, presumably in response to the concern that many secondary claims are meritless.

* * *

Q.3. The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small businesses, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued

just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

A.3. In addition to the step recommended in the previous answer, the best way to deal with the cost issue with respect to the activities of secondary participants is to adopt some form of proportionate liability for those found responsible. As I indicated in my testimony, I favor the sort of proportionate liability framework found in the Dodd-Domenici bill, S.1976.

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Q.4(1). Senator Metzenbaum has proposed reinstating aiding and abetting liability. How do you think the Supreme Court should interpret the Metzenbaum language recreating aiding and abetting liability?

A.4(1). The language in the Metzenbaum amendment is very open-ended, designed simply to overrule *Bank of Denver*. In the absence of clarifying legislative history, I would interpret it to mean that the courts are to return to the business of fleshing out on their own the body of aiding and abetting law, as they had been doing prior to the Court's decision.

Q.4(2). Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions"?

A.4(2). I would agree, as I indicated earlier, that some unnecessary confusion could be avoided by adopting a clearer statutory standard for aiding and abetting liability. However, I would doubt that it would create further confusion. With appropriate legislative history, it might even decrease it somewhat.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM
MARK J. GRIFFIN

Q.1 How will securities law enforcement change if Bank of Denver is allowed to stand?

What types of behavior would no longer be actionable?

Would there be more or fewer settlements?

A.1 Aiding and abetting liability, which is derived from common law and criminal law, confers liability on those who may not directly violate the law, but who provide substantial assistance to the unlawful acts of others. Prior to the Supreme Court's April 19, 1994, decision in *Central Bank of Denver. N.A. v. First Interstate Bank of Denver, N.A.*, appellate courts in nearly every circuit had recognized the liability of those who aid and abet violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Indeed. the Supreme Court's decision may appropriately be characterized as one of the most dramatic constrictions of the scope of Rule 10b-5 since the rule was adopted more than 50 years ago.

Aiding and abetting civil liability imposes an appropriate standard of diligence and care on professionals, such as attorneys and accountants, without whose assistance many financial frauds could not be perpetrated. Investors in publicly traded companies rely on the honesty and integrity of these professionals when making investment decisions. In essence, these professionals function as "gatekeepers," providing a degree of comfort to the investing public about the financial integrity of investments. As a result, our securities regulatory and enforcement system has created incentives for these professionals to exercise due care -- and avoid recklessness or intentional misconduct -- in securities transactions. This is accomplished by conferring aiding and abetting liability on those professionals who may facilitate a fraud committed by their clients. Aiding and abetting liability has been an important tool used by defrauded investors who seek recovery of their losses from accountants, lawyers and other professionals and also has been used by government regulators to deter professionals from lending their imprimatur to fraudulent conduct.

The Supreme Court's decision in *Central Bank of Denver* blocks recourse for defrauded investors because it eliminates a major source of liability for these professionals who are such an integral part of the capital raising process. The biggest beneficiary of

the Supreme Court's decision likely will be the accounting profession, and to a lesser extent, attorneys and broker-dealers. It is deeply troubling to NASAA that, as a result of the Court's decision, those professionals who substantially and knowingly assist a securities law violation may be in a position to avoid sanctions all together. One consequence of the *Central Bank* decision is that it will be difficult, if not impossible, for investors in many cases to recover financial losses due to fraud. Investors who are defrauded often have found that the "primary violators" are unable to meet all or most of the losses incurred, and so plaintiffs have sought recovery from the professionals, such as accountants and lawyers, who have aided and abetted the wrongdoing. As a result of the Supreme Court's decision, investors may no longer be able to recover from these professionals when they substantially assist in a securities fraud, even if these professionals act knowingly or with a high degree of recklessness.

Significantly, it is generally believed that the impact of the decision extends beyond private litigants and reaches actions brought by the Securities and Exchange Commission (SEC) itself. As such, the Commission would be precluded from bringing aiding and abetting actions under Section 10(b) and Rule 10b-5. In testimony before the Subcommittee on Securities, SEC Chairman Arthur Levitt pointed out the importance of aiding and abetting liability to the Commission's enforcement program:[1]

> The Commission itself has frequently relied on the aiding and abetting theory of liability, not only Section 10(b) and Rule 10b-5, but also with respect to other substantive provisions that do not explicitly refer to aiding and abetting. Out of about 420 pending Commission cases, we have identified about 80 cases in which the Commission has asserted an aiding and abetting claim not expressly provided by statute. Most of these cases include other counts in which the alleged aider and abettor is charged as a primary violator. In at least 25 pending Commission injunctive actions, however, one or more defendants are charged solely under an aiding and abetting theory of liability.

In addition, the *Central Bank* decision casts at least some doubt on the continued viability of certain other forms of secondary liability under the securities laws, such as *respondeat superior*. (*Respondeat superior* allows private plaintiffs to recover from employers for the actions of their employees, without regard to whether the employer acted in "good faith" under Section 20(a) of the Exchange Act.) While the Commission has not been overly reliant on this theory, it is NASAA's understanding that private plaintiffs frequently use it. Some commentators have suggested that the Court's analysis in *Central Bank* would seem to apply to all the statutory provisions administered

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[1] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission "Concerning the Central Bank of Denver Decision," before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, May 12, 1994, pp 7-8

by the Commission. These commentators have opined that the logic of the decision would extend to each of the express remedy provisions of the Securities Act and Securities Exchange Act, because the Court found that those provisions do not reach aiding and abetting liability.

One response to *Central Bank* may be that private litigants and the SEC assert primary violations in appropriate cases. In addition, although most private actions against aiders and abettors will be precluded as a result of the *Central Bank* decision, the Securities and Exchange Commission may have alternatives to aiding and abetting liability. In fact, one prominent defense attorney pointed out that it is likely that a heavier burden will be placed on the Commission to initiate its own enforcement actions, rather than rely on private litigation, because certain conduct not redressable by private parties may be reachable by the Commission in an administrative forum.[2]

That the Commission may have the authority to pursue aiders and abettors in certain administrative forums is of little comfort to NASAA. The fact is that government regulators currently do not have -- and never will have -- the resources needed to pursue all wrongdoers in our capital markets. Our system relies on private attorneys general to assist in the detection of fraudulent activity and in the prosecution of those individuals who carry out the fraudulent acts, as well as those who assist in such wrongful conduct. With over 14,000 reporting companies, the SEC cannot be expected to as vigilant as the individual shareholders in detecting and remedying fraud.

In conclusion, NASAA would emphasize that an important lesson of the massive financial frauds of the 1980s is that these schemes often involve not only primary wrongdoers who are central to the criminal enterprise, but also the professionals -- such as lawyers and accountants -- who aid and abet the fraud. In many instances, these financial crimes could not have succeeded without the participation of the accounting firms and law firms that advised and conferred credibility upon the enterprises. It would be unfortunate if *Central Bank* were allowed to stand and, as a result, private litigants no longer could pursue actions against these individuals. The salient question for securities law enforcement is whether *Central Bank* promotes more vigilance and rectitude on the part of professionals in securities fraud cases, or less. If the answer is less, then Congress, against the backdrop of so much professional recklessness in the 1980s, ought to see the clear necessity of restoring the rights denied by *Central Bank*.

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[2] Letter dated May 12, 1994, from Harvey L. Pitt, Partner, Fried, Frank, Harris, Shriver & Jacobsen, Washington, D.C. to Senator Christopher J. Dodd Chairman, Securities Subcommittee, regarding "The Supreme Court's Recent *Central Bank of Denver* Decision."

Q.2 In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

A.2 First, NASAA would like to take this opportunity to once again encourage the Senate Banking Committee and, indeed, the full Congress, to enact legislation to reverse the Supreme Court's *Central Bank* decision and to explicitly restore the authority under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, for the SEC and private litigants to bring appropriate actions against persons who aid and abet securities fraud. Such legislation is essential to maintaining the integrity of the marketplace and to providing defrauded investors with adequate means of redress.

What standards should be articulated in any such legislation in order to protect against vexatious litigation and the lack of predictability in such suits? NASAA suggests that such legislation should reaffirm what virtually every lower federal court to deal with the issue has held: that recklessness is the culpability standard under Section 10(b). The legislation could define aiding and abetting in traditional terms as involving: (1) a primary violation of the securities laws; (2) knowledge of, or recklessness with respect to, the primary violation; and (3) substantial assistance. Such a three-pronged test should adequately protect against the threat of vexatious litigation. At the same time, NASAA suggests that these standards should not be so high as to render the legislation meaningless in practical effect.

Certainly, there should be ways to protect against vexatious litigation without throwing out entirely an important means of redress for defrauded investors seeking to be made whole. While NASAA does not subscribe to the view that we are in the midst of a litigation "explosion" when it comes to securities fraud suits, the Association has been closely examining the class action litigation process to determine where changes may be necessary and to identify reforms that may benefit defrauded investors and unfairly targeted companies alike. Given the investor protection mission of state securities regulation, the main question for NASAA centers around the unacceptable level of fraud and abuse that exists in today's capital markets. As such, a main focus of our review is to identify areas where investors can be better served by the litigation system. After completing our work, NASAA certainly would be willing to share the results of this in-depth review with the Subcommittee and other interested Members of Congress.

Q.3 The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

A.3 While NASAA understands the tendency of the Supreme Court to subscribe to anecdotal accounts of the injurious effects of vexatious litigation, the Association cautions that the legislation ought not to be based on the Supreme Court's parroting of a popular notion, particularly one that may lack a solid foundation of fact. The Supreme Court lacks the dynamics of the legislative fact-finding process which must take into account not only anecdotal, but also empirical evidence. For example, consider the following:

- o Despite claims to the contrary, over the last 20 years stock offerings and stock trading activities have increased dramatically (and currently are at all-time record levels), yet securities class action lawsuits today are at essentially the same level as some 20 years ago.[3]

- o The number of securities fraud class action lawsuits actually filed is approximately 300 per year, out of total new federal suit court filings of approximately 225,000 suits per year. In other words, securities actions represent .13 percent of the total federal caseload. As a percentage of total federal court filings, securities class actions have declined sharply over the past 20 years. Total federal court filings have grown by 122 percent, from

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[3] For information regarding the level of <u>capital raising activity</u>, see the April 25, 1994, letter from Joel Seligman, professor of law at The University of Michigan Law School to NASAA President Craig Goettsch. In that letter, Mr. Seligman says: "For all the emotional appeal of arguments that excessive litigation is destroying capital formation, existing data illustrate a quite different picture. In 1992 the Securities and Exchange Commission reported in its Annual Report:

> Despite general economic conditions, the total dollar amount of securities filed for registration with the SEC during 1992 reached a record of over $700 billion, a 40 percent increase from the approximately $500 billion registered last year. The number of issuers accessing the public markets for the first time soared, with initial public offering (IPO) filings of equity or debt reaching $66.5 billion, an increase of about 53 percent from the $43.6 billion filed in 1991. (SEC Ann. Rep. 52 (1992))

In 1993 the Commission reported even more impressive results.

> The decline in interest rates, the burgeoning need for capital for businesses, small and large, and investor demand helped to fuel a record level of offerings filed for registration in 1993. More than $868 billion in securities were filed for registration, including over $112 billion of initial public offerings, equity and debt, and over $46 billion by foreign companies. (SEC Ann. Rep. 51 (1993))"

For information concerning the number of <u>securities class action lawsuits</u> filed in the United States, see the Statement of William McLucas, Director, Division of Enforcement, U.S. Securities and Exchange Commission, "Concerning Private Litigation Under the Federal Securities Laws," before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate, June 17, 1993, Appendix A. The source cited in the McLucas testimony is the Administrative Office of the United States Courts

103,530 in 1974 to 229,850 in 1993, while the number of securities class actions filed has declined by 2.3 percent, from 305 in 1974 to 298 in 1993.[4]

o In a study designed to calculate any correlation between imminent litigation and a single day's 10 percent decline in the price of a company's exchange listed stock, the results were less than dramatic: only 2.8 percent of such companies were the subject of a lawsuit.[5]

o While there are more than 14,000 U.S. companies reporting to the SEC, only 113 of them were sued in securities class action suits in 1992. In 1991, only 122 companies were sued. As such, it is clear that less than one percent of U.S. public companies are sued for securities fraud each year.[6] This cannot be described as a "litigation explosion," nor is it fair to characterize this level of litigation as unfairly burdening public companies in the U.S.

Finally, NASAA would repeat a point the Association has made in previous testimony before the Subcommittee: Existing case law clearly spells out when recovery under Section 10(b) and Rule 10b-5 is available. Plaintiffs in these lawsuits must prove that:

* The plaintiff was a purchaser or seller of securities;

* The defendant engaged in a fraud, manipulation or deception;

* The fraud, manipulation or deception was in connection with the purchase or sale of securities;

* The defendant acted with scienter;

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[4] See, Testimony of William McLucas, Director, Division of Enforcement, U.S Securities and Exchange Commission, "Concerning Private Litigation Under the Federal Securities Laws," Before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 17, 1993, Appendix A.

[5] See "Private Litigation Under the Federal Securities Laws," Hearings Before The Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 103rd Congress, First Session, S Hrg 103-431, p 878-883, "PVR (Princeton Venture Research Inc.) Analysis of One-Day Common Stock Price Declines Greater than or Equal to 10%, 1986-1992."

[6] See "Private Litigation Under the Federal Securities Laws," Hearings Before The Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, U.S Senate, 103rd Congress, First Session, S Hrg 103-431, pp 776-792, "Statement of James M Newman, Publisher & Editor, Securities Class Action Alert."

* The defendant's misstatement or nondisclosure was material;

* The plaintiff reasonably relied upon the defendant's misstatement or nondisclosure;

* The plaintiff was damaged; and

* The defendant's conduct caused the plaintiff's damages.

NASAA is not so naive as to argue that there never has been meritless or questionable securities fraud actions filed in the courts. However, satisfying this burden of proof requires considerable evidence of wrongdoing. In addition, liability is based upon deliberate and intentional fraud, not merely negligent violations. As a result, NASAA would strongly oppose any changes to the current standards that would have the effect of rendering such remedies all but meaningless in the real world.

Q.4 Senator Metzenbaum has proposed reinstating aiding and abetting liability.

How do you think the Supreme Court should interpret the Metzenbaum language recreating aiding and abetting liability?

Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions"?

A.4 NASAA commends Senator Metzenbaum for focusing attention on the very real need for Congress to take action to reverse the Supreme Court's decision in *Central Bank*. NASAA knows Senator Metzenbaum to be a long-time advocate of strong and effective securities laws and a true friend of the small investor. Having said that, NASAA recognizes that some commentators have pointed out potential problems with the precise wording of Senator Metzenbaum's legislation and have suggested that it would only further muddy the waters for these lawsuits.

With respect to the questions regarding Senator Metzenbaum's proposed legislative language, you should know that NASAA has not endorsed any specific language with regard to restoring aiding and abetting liability. The Association does believe that the following elements could form the basis of a test for determining liability in instances of aiding and abetting: (1) a primary violation of the securities laws; (2) knowledge of, or recklessness with respect to, the primary violation; and (3) substantial assistance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM
STUART J. KASWELL

Q.1. Effect of *Central Bank of Denver*

(a) How will securities law enforcement change if *Central Bank of Denver* is allowed to stand?

Even after *Central Bank of Denver*, which held that there is no implied private right of action against aiders and abettors under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange") and Rule 10b-5 thereunder, investors who are defrauded are well protected. The Securities and Exchange Commission ("SEC" or the "Commission") has a full arsenal of remedies to police the markets. The SEC still will be permitted to bring civil injunctive actions to enjoin those who commit primary violations of Section 10(b) of the Exchange Act [1] and to obtain disgorgement and substantial civil money penalties against them.[2]

The SEC, by statute, also has full authority in its administrative proceedings to discipline broker-dealers, [3] investment advisers, [4] other regulated entities, [5] and their associated persons for aiding and abetting securities law violations (including Section 10(b) violations). For example, the Commission may censure, limit, suspend, or revoke the registration of a broker-dealer that has willfully "aided, abetted, counseled, commanded, induced, or procured the violation by any person of the [securities laws or rules thereunder]." [6] Possible sanctions include suspension or revocation of registration or right of association

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1 *Central Bank of Denver* did not reach the issue of whether the SEC has authority to bring an action under Section 10(b) on an aiding and abetting theory.

2 Section 21(d) of the Exchange Act. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act") permits the Commission to seek a money penalty in court for any violation of the Exchange Act, including a violation of Section 10(b). A court may impose a penalty of up to the greater of $100,000 against a natural person, and up to $500,000 per violation for others, or the greater of the gross amount of pecuniary gain to the defendant, in certain instances. Section 21(d)(3) of the Exchange Act.

3 Section 15(b) of the Exchange Act.

4 Section 203 of the Investment Advisers Act of 1940 ("Advisers Act")

5 *See, e.g.*, Sections 15B (municipal securities dealers) and 15C (government securities dealers).

6 Section 15(b)(4)(E) of the Exchange Act (emphasis added).

as well as money penalties of up to $100,000 per violation for a natural person and up to $500,000 per violation for others. [7]

The SEC's Rule 2(e), which governs the practice before the SEC of attorneys and accountants, authorizes the SEC to suspend, revoke, or place limitations on the right of any attorney or accountant to appear before the agency if it finds that the individual violated any provisions of the securities laws or aided or abetted another's violation, including a violation of Section 10(b).

In the most egregious cases, aiders and abettors of Section 10(b) violations can be criminally charged by virtue of Section 32 of the Exchange Act (making any willful violation of the statue a criminal offense) and 18 U.S.C. § 2 (the general criminal aiding and abetting statute).

In addition to the SEC, the securities self-regulatory organizations ("SROs"), such as the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers, Inc. ("NASD"), regulate the conduct of broker-dealers and bring proceedings against their members and associated persons for violations of the securities laws and also of SRO rules, which provide for even broader investor protections than do the securities laws themselves. These proceedings may lead to substantial fines, orders of restitution, and/or revocation of membership. Finally, states may impose penalties against persons who commit securities fraud under their respective securities laws.

(b) What type of behavior would no longer be actionable?

Rule 10b-5 still makes it illegal for any person to defraud, make a false statement, or engage in a fraudulent act, in connection with the purchase or sale of a security. If wrongdoers lie, cheat, or steal, the SEC can and should bring an enforcement action against them under Rule 10b-5.

As SEC Chairman Arthur Levitt testified at the May 12, 1994 hearing on this issue, "the Commission's preliminary assessment is that its enforcement program can continue to operate effectively under these circumstances. The Commission believes that some enforcement remedy will continue to be available against most defendants that the Commission previously would have pursued on an aiding and abetting theory." [8]

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7 *See, e.g.*, Section 21B of the Exchange Act (covering broker-dealers, municipal securities dealers, government securities dealers, transfer agents, clearing agencies, and their associated persons, and permits the imposition of penalties for willfully aiding or abetting such violations). Congress added this subsection as part of the Remedies Act.

8 *See* Statement of Arthur Levitt, Chairman, SEC, Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, United States Senate (May 12, 1994) [hereinafter "Levitt Testimony"].

To the extent that private plaintiffs may no longer bring cases under Section 10(b) of the Exchange Act for aiding and abetting, some defendants may not be liable for alleged violations. However, the plaintiffs' bar can be expected simply to allege that persons were direct violators of Section 10(b). SIA believes that persons who have violated Section 10(b) of the Exchange Act should be liable to legally injured parties and should have to pay compensation promptly. As discussed in response to Question 3, SIA believes that aiding and abetting theory created a morass of conflicting cases and liability, that served only to augment the private "litigation tax."

(c) Would there be more or fewer settlements?

It may be difficult to determine whether there will be more or fewer settlements with the SEC. We may, however, see an increase in the number of cases brought administratively.[9] As discussed in Question 1(a) above, the SEC, by statute, has full authority in its administrative proceedings to discipline broker-dealers, investment advisers, other regulated entities, and their associated persons for aiding and abetting securities law violations (including Section 10(b) violations). Possible sanctions include suspension or revocation of registration of right of association as well as civil money penalties of up to $100,000 per violation for a natural person and up to $500,000 per violation for others.

Q.2. <u>Problems with Previous Aiding and Abetting Liability</u>

> In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

SIA participated as *amicus curiae* in *Central Bank of Denver* and believes that the Supreme Court made the right decision, both because it correctly interpreted Section 10(b) and also because limiting secondary liability represents the best public policy. SIA previously testified before this Subcommittee on the importance of the principle of investor protection and the need for appropriate remedies for victims of fraud.[10] At the same time, we testified that the private civil liability system under the securities laws has not served the public at large well and has imposed disproportionate and dysfunctional burdens on issuers, underwriters, accountants, and others.

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9 *See* Levitt Testimony at 2.
"It is likely, however, that after *Central Bank of Denver* the Commission will bring more cases under its administrative authority, which does not provide for civil money penalties as to non-regulated entities."

10 *See* Statement of Marc E. Lackritz, President SIA Before the Subcommittee on Securities, Committee on Banking, Housing, and Urban Affairs, United States Senate (July 21, 1993)

SIA would discourage any efforts to restore aiding and abetting. Aiding and abetting, whatever the formulation, cast a net of liability that was too broad and only helped an aggressive plaintiff's bar draw in more defendants at the periphery. Restoring that mess will not provide meaningful investor protection and will not create more jobs except for lawyers.

Q.3. New and Small Business

The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

SIA does not support refinements of aiding and abetting liability. We believe that *Central Bank of Denver* reaches the right result. Even though the case by itself is not likely to eliminate all meritless litigation -- it is a welcome step in the right direction. We believe that the federal securities laws should continue to provide strong deterrence against wrongdoing and appropriate remedies for defrauded investors, yet not impair the capital-raising ability of U.S. businesses. From a public policy viewpoint, the balance between providing remedies and encouraging capital formation has, in recent decades, swung too far toward remedies.

As the SIA has previously testified before this Subcommittee, the securities class action system -- which encourages strike suits whenever a stock price drops -- in effect amounts to a "litigation tax" on capital formation. This "tax" drains funds available to produce new products, expand plants, or hire new workers. SIA believes many of these suits are brought without merit by aggressive trial lawyers and their professional plaintiffs.

Q.4. Metzenbaum Amendment

How do you think the Supreme Court should interpret the Metzenbaum language recreating aiding and abetting liability?

SIA strongly opposes any legislation providing for a private right of action for aiding and abetting a violation of Section 10(b) of the Exchange Act. The Metzenbaum amendment would recreate aiding and abetting liability by simply inserting the "aiding and abetting" language into the statute. As discussed in more detail below, SIA believes that Congress should reject quick fixes for aiding

and abetting. We believe that nothing is broken. The Supreme Court's decision in *Central Bank of Denver* is both good law and good policy.

> Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on business transactions?"

SIA agrees that the Metzenbaum amendment leaves many more questions than it answers. The Metzenbaum language would create further confusion in this area because the contours of aiding and abetting liability would remain vague and elastic. As the Supreme Court observed in its decision, the "rules for determining aiding and abetting liability [under the lower court's decisions] are unclear in 'an area that demands certainty and predictability.'" [11] In addition, the Solicitor General's Office, in its brief urging the Supreme Court to grant *certiorari*, cited this lack of certainty as a reason the Court should take the case. [12] SIA made this same point in its brief on the merits in *Central Bank:*

> With respect to the "knowledge" requirement, courts have established unique but amorphous and unpredictable rules applicable only to the aiding and abetting right of action that variously require proof of "actual knowledge" in some circumstances and some form of "recklessness" in others, depending on a number of variables such as duties owed to the primary violator and, in some jurisdictions, a highly fat specific "sliding scale" of culpability .... Moreover, the "substantial assistance" element of the proposed §10(b) implied private right for aiding and abetting has spawned yet another separate and complex doctrinal quagmire. [13]

As reflected in SIA's written testimony, enacting a "quick fix" solution that restored aiding and abetting liability merely would plunge us back into this quagmire.

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11 62 U S L.W. at 4237 (citation omitted).

12 Brief of the United States at 5-6.

13 Brief of SIA at 8-9 (citations omitted)

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM
HARVEY J. GOLDSCHMID

Question 1: How will securities law enforcement change if Bank of Denver is allowed to stand?

What types of behavior would no longer be actionable?
Would there be more or fewer settlements?

Answer to Question 1: The majority's emphasis in Central Bank of Denver on the text of Section 10(b) leads me to doubt that the SEC will be permitted to impose aiding and abetting liability in the future. Thus, absent a legislative overruling of the case, this basic enforcement tool will be unavailable to private plaintiffs and except for special instances (e.g., disciplinary proceedings against brokers and dealers, Rule 2(e) proceedings, criminal cases), unavailable to the SEC. I am optimistic about the ability of the "indirectly" language in Section 10(b) to fill much of the gap created by the Supreme Court's unfortunate holding, but even if my optimism proves warranted, it will take years of confusing and wasteful litigation before the gap is filled; during this period, the wrong message may well be conveyed to lawyers, accountants, and others. If, contrary to my hope, a narrow reading is given to the word "indirectly," then a large assortment of professionals -- the critical "gatekeepers" on whom the financial integrity of our securities markets significantly depends -- will be free of an essential spur to proper vigilence. A narrow reading of the word "indirectly" would seriously damage incentives for securities lawyers and other professionals to exercise due care -- and avoid recklessness -- and, therefore, pose a grave long-term threat to capital formation and the nation's securities markets.

I asked in my Statement to the Subcommittee:

> "Has an outside lawyer who knows of a CEO's financial wrongdoing and a corporation's related materially misleading disclosure documents, but fails to warn the board of directors or to attempt to stop the misleading disclosure, been 'indirectly' involved in a proscribed activity, or has he or she merely given legally permissible 'aid' to those who violated Section 10(b)?"

A broad reading of "indirectly" would -- and should -- result in liability for a senior lawyer with a duty to the corporate entity. A narrow reading, would permit the lawyer to avoid liability. Indeed, under a narrow reading, lawyers who draft misleading disclosure documents with reckless indifference to the truth of material statements would be immune from liability for the damage they create.

Given the uncertainty created by the Supreme Court's Central Bank of Denver decision, I see no realistic way of forecasting whether there will be more or fewer settlements. But without legislative action on aiding and abetting there certainly will be confusion and wasteful litigation at a minimum; and there will be grave harm to the SEC's enforcement program and to our securities markets if the word "indirectly" in Section 10(b) and other statutory provisions available to the SEC are not used to fill the gap created by Supreme Court's unfortunate holding.

Question 2: In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

Answer to Question 2: First, I do not believe that eliminating aiding and abetting liability serves the goals of fair dealing and efficiency in the securities markets. Indeed, for all of reasons I have set forth in my testimony, just the opposite is true. The best way to provide predictability, avoid vexations litigation, and preserve the effectiveness of our securities markets is to enact legislation with the kind of definition of aiding and abetting and with the other provisions that I have recommended in the Statement I submitted to the Subcommittee.

Question 3: The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuit. Because they are by nature more volatile, they are frequently sued just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

Answer to Question 3: New and small businesses should be at least as concerned about the integrity of our securities markets as other interested parties. Their ability to raise capital successfully is dependent on that integrity. The type of defined aiding and abetting legislation that I have recommended and other balanced litigation reforms (e.g., a carefully tailored proportionate liability provision, appropriate improvements to the "safe harbor" for forward-looking statements) should go far toward protecting those providing professional services by discouraging meritless lawsuits and coercive statements.

Question 4: Senator Metzenbaum has proposed reinstating aiding and abetting liability. Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions"?

Answer to Question 4: My preference is for the kind of defined aiding and abetting provision that I have recommended to the Subcommittee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM

EUGENE GOLDMAN

Topic: Effect of Central Bank of Denver

Question 1: How will securities law enforcement change if Bank of Denver is allowed to stand?

What types of behavior would no longer be actionable?

Would there be more or fewer settlements?

Answer: Private suits will be more narrowly tailored to plead against only those individuals and entities which actually committed violations of Rule 10b-5. Actions against "deep pockets" whose conduct goes beyond the periphery of a primary violation would be subject to dismissal.

However, Central Bank does not immunize the behavior of outside professionals who are participants in a fraudulent scheme. It should be noted that the Supreme Court in Central Bank emphasized that outside professionals are not free from liability for their involvement in fraudulent schemes. As stated by the Supreme Court, any

> person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material statement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5 assuming all of the requirements for primary liability [are met].

The recent decision of the United States District Court for Central California in In re ZZZZ Best Securities Litigation, No. CV-87-3574-RSWL (8/12/94) illustrates that deep concerns that real wrongdoers will escape liability under Central Bank may be overblown. The court denied summary judgment on claims against ZZZZ Best's outside auditors, Ernst & Whinney, where plaintiffs submitted evidence suggesting that Ernst & Whinney was extensively involved in the creation of allegedly misleading financial data released to the public. In short, the court said, the plaintiffs alleged a primary Rule 10b-5 violation against the auditing firm.

I believe there will be fewer settlements because there will be fewer outsider defendants who will be sued in the first place unless primary violations can be pleaded.

Question 2: In its decision, the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

Answer: In the event the Congress determines to authorize aiding and abetting liability, I would recommend that you establish statutory prerequisites for imposing such liability, including a showing of some actual knowledge of the primary violation. Such an express standard would obviously facilitate uniform judicial treatment of aiding and abetting liability.

Question 3: The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

Answer: As stated in response to Question 2, I would recommend a specific statutory standard which includes the need to show some actual knowledge of a primary violation.

Much of the problem stemming from suits based on fluctuation in stock prices has been addressed and is continuing to be addressed responsibly by the Securities and Exchange Commission in its promulgation of rules and proposed rules providing a safe harbor for companies making good faith projections about their future performance. Consideration should be given to cross-referencing these rules in the legislative history of a statutory aiding and abetting standard.

Question 4: Senator Metzenbaum has proposed reinstating aiding and abetting liability.

Q1: How do you think the Supreme Court should interpret the Metzenbaum language recreating aiding and abetting liability?

Q2: Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has

already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions?"

Answer: I believe the Supreme Court should interpret the Metzenbaum amendment as reflecting Congress' express authorization of private action against aiders and abettors. However, the inconsistency in the scope and application of the aiding and abetting standards which predated Central Bank would not be rectified by the Metzenbaum amendment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DOMENICI FROM

DAVID S. RUDER

Topic: Effect of Central Bank of Denver

Question: How will securities law enforcement change if Bank of Denver is allowed to stand?

> Securities law enforcement would be affected negatively if Central Bank of Denver is allowed to stand. The Securities and Exchange Commission and private litigants need aiding and abetting as an appropriate means of finding remedies.

Question: What types of behavior would no longer be actionable?

> Active assistance to securities law fraud by accountants, banks, lawyers and others who cannot be classified as participants or controlling persons would no longer be actionable.

Question: Would there be more or fewer settlements?

> There would be fewer settlements because the number of actions against non-participants would decrease in number.

Topic: Problems with Previous Aiding and Abetting Liability

Question: In its decision. the Supreme Court mentioned that aiding and abetting liability could "disserve the goals of fair dealing and efficiency in the securities markets." Specifically, they mentioned lack of predictability and vexatious litigation. If we were to restore aiding and abetting liability, how would you have us protect against these problems?

> If aiding and abetting were restored, problems of lack of predictability and vexatious litigation might increase, but not markedly. The reason vexatious litigation might increase is that by restoring aiding and abetting a greater number of wrong doers would be subject to suit by those unscrupulous lawyers who are inclined to bring vexatious suits. Protection against vexatious litigation can be found in Rule 11 of the Federal Rules of Civil Procedure.
>
> Lack of predictability is inherent in securities law fraud suits because the outcome of such suits is highly depending upon the underlying facts. This lack of predictability is not a sufficient reason to refrain from

bringing suits against culpable wrong doers. A measure of protection can be obtained by making clear that aiding and abetting suits cannot be based upon inaction and that the required mental state would include recklessness only of the highest degree.

Topic: New and Small Business

Question: The Supreme Court mentioned the particular problems aiding and abetting liability creates for new and small business, which has been particularly hard hit by meritless lawsuits. Because they are by nature more volatile, they are frequently sued just because of fluctuation in stock prices. What refinements of aiding and abetting liability do you recommend to best protect those providing professional services to these innocent businesses from meritless lawsuits and coercive settlements?

If new and small businesses are innocent, they have little to fear from litigation. If they are engaged in fraudulent activity, their investors deserve protection as much as do investors in large businesses. In any event, the businesses themselves would be participants in a fraud and not aiders and abettors.

In order to protect non-participants providing professional services, the required mental state for aiding and abetting should include recklessness only of the highest degree. With regard to professionals who are paid fees, Congress might consider limiting damage awards to a multiple of those fees.

Topic: Metzenbaum Amendment

Question: Senator Metzenbaum has proposed reinstating aiding and abetting liability.

Q.1. How do you think the Supreme Court would (sic) interpret the Metzenbaum language recreating aiding and abetting liability?

Q.2. Wouldn't you agree that the Metzenbaum language would create further confusion in this area that the Supreme Court has already characterized as "not a satisfactory basis for a rule of liability imposed on the conduct of business transactions."?

Merely reinstating aiding and abetting liability would not be the best solution. That liability should be reinstated through language making clear that aiding and abetting suits cannot be based upon inaction and that the required mental state includes recklessness only of the highest degree.

Affordable Housing Disposition Program

Resolution Trust Corporation

AFFORDABLE HOUSING DISPOSITION PROGRAM (AHDP)
BIMONTHLY REPORT

JANUARY/FEBRUARY 1994

By February 28, 1994, the Affordable Housing Disposition program had sold over 82,000 housing dwellings for $1.2 billion. This includes over 20,000 single-family dwellings and over 57,000 multifamily units. Program milestones from inception in 1990 to date:

- 20,546 single-family dwellings sold (24,625 units) and closed for $563 million;

- 57,597 multifamily units (25,063 solely for low- and very low-income tenants) in 620 properties sold and closed for $652 million;

- Total housing dwelling units sold and closed to date: 82,222 for $1.2 billion.

Over 115 nonprofit entities (42 public agencies and 76 nonprofit organizations) have purchased over 200 multifamily properties. At the same time, over 375 such entities (87 public agencies and 290 nonprofits) have bought over 1,500 single-family properties.

Other significant trends: 31 percent of multifamily properties have been seller financed, and 22 percent of single-family home sales have been seller financed.

Currently, the program has about 200 multifamily properties available for sale, and about 3,000 single-family properties left.

FDIC Board, Affordable Housing Advisory Board Approve RTC-FDIC Unification Plans

On April 17, 1994, the FDIC Board of Directors approved the unification plan of the RTC and FDIC affordable housing programs. Earlier, on March 15, the newly-appointed Affordable Housing Advisory Board (AHAB) approved the plan, which is to be implemented in full by August 17, 1994. Among key elements of the unification agreement are: RTC will seller finance FDIC single-family property sales; RTC will market some FDIC multifamily properties under its Direct Sales Program; the two agencies will hold joint sales events, including at least two auctions in 1994 and two in 1995; both agencies will use the same purchaser eligibility certification forms; the agencies will jointly market their sales. The new AHAB board expressed concern about staff attrition and lose of expertise gained in affordable housing. Boardmember Edwin S. Crawford "strongly urged" RTC to offer "retention bonuses" to keep staff on board until the sunset date at the end of 1995. "For all the good work done in helping solve this national housing problem, to lose this expertise now so close to the goaline is very sad," said Crawford.

Two Floridians Convicted of Fraud in Affordable Housing Program

In February 1994, a Florida father and son were convicted of a felony offense in conspiring to tamper with RTC affordable housing income qualifying rules. James Claassen of Tampa, FL, essentially used his father, Richard, to purchase a single-family property at auction for $500 in September 1991. The son was ineligible as an FDIC bank examiner to bid on RTC property. His father fraudulently filled out required income certification forms, presented false income tax returns, and agreed to live in the property one year. But shortly after closing, the father assigned a quit claim deed to his son, and the property was rented. The Claassens were sentenced to 36 months probation, six months of home detention and a fine of $150.

19 Properties Create Housing in Lowell, MA, By Nonperforming Loan Donation

On January 10, 1994, for the first time RTC conveyed a nonperforming loan to create affordable housing from the 19 vacant, eyesore properties it covered that were scattered throughout the city of Lowell, MA. The complicated deal turned over more than 100 units in the 19 properties to the Lowell Development Nominee Trust (LDNT), which in turn donated 6 properties to the City of Lowell and 9 to the Coalition for a Better Acre, which had first flagged them from the rolls of the failed Comfed S & L in 1991. Cheryl Walker and Mary Galbally of RTC Valley Forge, PA, pulled the bad note from a bulk sale going to investors to enable the affordable housing to happen. Said CBA executive director Neal Newman: "As one of the first bulk transfers of government-held property to nonprofits, it is an important process to evaluate for communities. We've stepped out

of the old paradigms."

Pima County (AZ) Buys 17 Properties in Bulk, Resells to Nonprofits

Following the model of the three bulk purchases by the Colorado Housing Finance Authority, by April 1994 Pima County (AZ) Industrial Development Agency had closed sale of 13 of 17 multifamily properties containing 817 units for $8.7 million. Included were five properties sold for $1. Twelve of the properties utilized the RTC Direct Sales Program bridge loan of 1 percent down payment. In order to serve the mentally ill, low-income families, and other populations, Pima County will turn over the properties to several nonprofit organizations, including Mercy Housing, Pride, Inc., and Christian Relief Services.

New Jersey Creates Special Entity to Finance Huge 376-unit Stony Hill Apartment Purchase by Nonprofit

Featured in the March 18, 1994, issue of the *New York Times*, the sale of the 376-unit Stony Hill apartments in Eatontown, NJ, closed on March 30. The project forced the New Jersey Housing Mortgage Finance Agency to create a new financing mechanism to fund the project. According to Monsignor William Linder, lead of the nonprofit purchaser New Community Corp., "We now have a model, and it's helped to make the state more activist in housing."

30 Phoenix Homeless Families Get Christmas Homes

During Christmas 1993, 15 Phoenix homeless families were literally taken off the streets under an emergency and transitional housing program of the nonprofit Community Housing Partnership and placed into transitional housing in 11 fourplexes bought from RTC. The Christmas before another Phoenix nonprofit, Labor's Community Service Agency, did something similar with 15 homeless families. A Phoenix tradition in the making?

Earthquake Victims Get Speedy Help to Buy Home in L.A.

The apartment building they managed wrecked by the January 17, 1994, earthquake in Los Angeles, Richard and Juanita Greene not only lost living quarters, but the financial base to close their purchase on an RTC home in Trona, CA. But RTC Newport Beach went to bat for them in the person of Sandra Hibler. In the emergency, the sales price was lowered from $30,000 to $20,000 and the Greenes were swiftly moved in under a rental agreement until closing.

Bulk Single-family Conveyance Blossoms in Montgomery, AL

RTC donation of 31 single-family properties to the City of Montgomery, AL, was approved on February 10, 1994; half are due to close by the end of May.

RTC

RESOLUTION TRUST CORPORATION

Resolving The Crisis
Restoring The Confidence

AFFORDABLE HOUSING DISPOSITION PROGRAM (AHDP)
SCORECARD

ACCOMPLISHMENTS THROUGH FEBRUARY 28, 1994

- Almost 82,300 dwellings sold and closed for $1.2 billion.
  - 20,546 single-family dwellings sold (24,623 units) and closed for $563 million.
  - 57,597 multifamily units (25,063 solely for low- and very low-income tenants) in 620 properties sold and closed for $652 million.
  - 337 multifamily properties (33,292 units) have been identified for the Direct Sales Program for public agencies and nonprofit organizations; 93 are under negotiation; 43 are under contract; and 74 have closed sales.
- 22 percent of all single-family homes sold have been seller financed by RTC totalling $148 million in sales and $137 million in loans; $58 million of single-family properties financed through RTC sponsored mortgage revenue bonds; 31 percent, or 194 of the multifamily properties have been seller financed.
- 74 percent of appraised value achieved for both single-family and multifamily properties with an overall return of 65 percent of book value.
- Average income of purchasers of single-family homes is $21,869 or 61 percent of national median income; average purchase price $27,401.
- Recent survey of buyers at 36 nationwide auctions and sealed bids shows 38 percent are minorities and 74 percent first-time buyers.
- Conducted over 237 single-family sales events, including auctions, sealed bids and homefairs in 32 states.

801 17th Street N.W. Washington, D.C. 20434

NYT
3-18-94

About Real Estate

New Jersey Aids Low-Income Project

By RACHELLE GARBARINE
Special to The New York Times

EATONTOWN, N.J. — Stony Hill Apartments, a 376-unit rental housing complex in this Monmouth County community, is about to make a comeback under new ownership and with at least 35 percent of its units reserved for families with low incomes.

The New Community Corporation, a nonprofit housing group in Newark, hopes to take over the project at the end of this month with help from a program introduced recently by the New Jersey Housing Mortgage Finance Agency. The semiautonomous state finance agency is providing a $350,000 five-year loan at 5.5 percent interest to cover down-payment and closing costs for the group's $6.7 million purchase of Stony Hill. The seller is the Resolution Trust Corporation, the Federal agency set up to dispose of the assets of failed savings and loans institutions.

Called the Affordable Housing Disposition Demonstration Program, it provides financial assistance to nonprofit housing groups buying multifamily rental properties and preserving them for low-income families. The buildings involved are in the hands of Federal agencies, which along with Resolution Trust include the Federal Deposit Insurance Corporation and the Department of Housing and Urban Development. The program is being financed with funds from the state agency's general operating budget, with the rest financed through Resolution Trust.

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Christiana Foglio, the agency's executive director, said the down-payment and closing-cost loans would be given to nonprofit borrowers at below-market interest rates and range in length from 5 to 20 years. She said project approval would be based on the track record of the nonprofit buyer, the number of affordable units generated and whether the rental stream would be sufficient to support operating costs.

The idea, Ms. Foglio said, is to get more nonprofit groups to take over federally owned properties and, in turn, increase the state's supply of rentals for low- and moderate-income households. She said the goal was to allocate as much as $5 million to help finance the purchase of about 1,000 rental units.

Those units will help meet what the state's Department of Community Affairs, which oversees the state's housing, estimates is a need for 100,000 residences, most of them rental units, for low- and moderate-income households through 1999. Such households earn less than 50 or 80 percent, respectively, of the median income of the areas in which they live.

The state initiative grew out of a need to keep the acquisition of the Stony Hill complex on track. The project is one of three in the state, together totaling 401 units, that are part of a national program begun in 1992 by Resolution Trust to encourage public agencies and nonprofit organizations to purchase multifamily rental properties in its portfolio.

Under that program, buyers must agree to set aside for 40 years at least 20 percent of the units for people earning no more than 50 percent of the median income in the area, and at least 15 percent of the units for those

earning no more than 65 percent of the area's median income. Resolution Trust also makes market-rate loans available for as much as 95 percent of the purchase price.

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To date, 342 rental properties nationwide, with a total of 33,453 units, have been made available under the program, a Resolution Trust spokesman said. Of that total, 116 properties have been sold or are under contract to be sold.

In New Jersey, the state housing finance agency tried to match nonprofit groups with the Resolution Trust properties and provide technical assistance. That was the case in the first two projects — one in Highlands, N.J., with 16 units, the other in Union City with 9 units. In both cases, the properties were transferred to the nonprofit groups by Resolution Trust at no cost because the cost to rehabilitate the project exceeded its appraised value.

For Stony Hill, the state agency expanded its role to finance the required $350,000 in down-payment costs, keeping the deal from falling through. The significance of the Stony Hill project, Ms. Foglio said, is "that it forced the agency to come up with a financing mechanism to generate the necessary down payment for nonprofits to acquire foreclosed properties."

Raymond M. Codey, director of development at the New Community Corporation, said he hoped to close on the property, which sits on 27 acres not far from Route 35, by the end of this month. He said his company, which is noted for its affordable residential developments in Newark, had pursued the project "to insure that it would be kept as an affordable and attractive place to live."

The one- to three-bedroom apartments at Stony Hill range in size from 812 to 1,155 square feet. A two-bedroom will cost $456 a month for a family of four making up to $29,560 a year; families making up to $33,670 annually will pay $611 for the same unit. The market-rate rent would be $750 to $765.

NATIONAL MORTGAGE NEWS
April 18, 1994

Create Housing from Thrift Assets

By STEPHEN S. ALLEN
Director, RTC Affordable Housing Disposition Program

(Mr. Allen recently spoke before the Affordable Housing Advisory Board regarding affordable housing being created from the assets of failed thrifts and banks. His prepared statement has been excerpted here as our **Open Forum** *report.)*

As of Jan. 31, RTC affordable housing had sold 81,500 dwellings for $1.2 billion.

These figures include 609 apartment buildings containing 56,716 multifamily units, as well as 20,397 single-family homes. We have seller financed 31% of our multifamily properties, and 22% of our single-family homes, for a total loan value of $263 million. Without RTC financing, almost one-third of multifamily and one-quarter of single-family sales might not have occurred.

Of 342 properties which have been identified for and included in our Direct Sales Program, 124 are actively being marketed or are under negotiation, 48 are under contract, and 68 have closed sales. Another 102 are being prepared with due diligence packages for marketing.

We continue to maintain a 74% return on appraised value for our properties, a recovery rate only slightly lower than the 81% achieved by higher priced and other non-affordable properties at RTC. The average home price is under $28,000 reaching low-income people with an average yearly income of less than $22,000. Three-quarters of our purchasers are first-time homebuyers.

We are very pleased to report on the status of meeting sales goals in 1993. We sold 151 multifamily properties, one more than our goal of 150. On single-family properties, we ran a little short of our planned goal of 4,000 home sales; we sold 3,589.

One reason for this is the increased number of single-family properties now in the inventory that are in serious need of rehabilitation and have limited or no value. As a result, we are revising our conveyance policy in order to convey real estate to non-profits and public agencies more efficiently when it is determined there is no value.

For 1994, our goal is to sell 3,080 single-family and 215 multifamily properties. The vast majority of properties are in three regions centered in Dallas, Atlanta, and Kansas City. Dallas has 90 multifamily properties alone as its goal.

In 1995, our sales goals will be to sell the remaining 643 single-family and 176 multifamily properties. These numbers are based on existing inventory; they do not include any multifamily properties coming into receivership from conservatorships, any new foreclosures, or any additional S&Ls that might be taken over by RTC.

The present drive to downsize RTC and merge with FDIC must occur at the same time as we achieve our sales goals for 1994 and fully merge with FDIC by October 1995. Our challenges continue; there is always one more corner to turn in our work, but we are prepared to meet the challenges ahead.

By Jan. 31, 42 public agencies had purchased 92 multifamily properties and 76 non-profit organizations had bought 122 multifamily properties. In summary, 118 non-profit or public agencies have bought over 200 multifamily properties in this program. This includes properties sold through the clearinghouse marketing program and the Direct Sales Program. For-profit entities have purchased 395 multifamily properties. A breakdown of public agencies buyers shows that 12 city governments, 14 city housing authorities, three state agencies, and five county or regional agencies have bought multifamily properties.

For example, the San Antonio Housing Authority has purchased 10 multifamily properties with over 1,400 RTC units for $12.5 million.

In partnership with the U.S. Army Weed and Seed program, the housing authority took 192 dilapidated homes donated by RTC, demolished two-thirds of them, and is building new homes on the land for low-income people previously renting public housing who are undergoing intensive homeownership counseling.

Thirty homes are already up; Banc One is financing the construction, and Fannie Mae is purchasing the loans.

Similarly, the Georgia Housing Finance Agency has had offers accepted on five RTC multifamily properties containing 380 units for $14 million. RTC is working closely with GHFA to act as an intermediary for resale of the properties to local non-profits. GHFA is providing bond financing, and intends to resell the properties to several non-profit organizations in the state and city housing authorities in Warner Robins and Clayton, Georgia.

Often we are asked by non-profit organizations and public agencies to assist them in purchasing other RTC assets outside of the affordable housing program. One such asset of interest is the non-performing loan. Non-profits and public agencies are interested in the real estate behind such a loan in order to find affordable housing.

In January 1994 RTC donated a non-performing loan to the city of Lowell, Mass., for the purposes of creating affordable housing in that economically depressed city.

The note had come into RTC's hands from the failed ComFed Savings Bank, and had no value.

The bad note had been owned by a real estate speculator and covered 100 units in 19 multifamily properties in downtown Lowell.

Catalyzing the whole effort was the non-profit Coalition for a Better Acre, which had discovered the blighted, vacant buildings, and wanting to revitalize the neighborhood, approached RTC in the hope of buying the property as affordable housing.

Our housing staff in Valley Forge, Pa., discovered that RTC did not hold the real estate, but rather the non-performing loan.

Valley Forge wisely pulled the note from a bulk sale of such loans to institutional investors because of its lack of value, and at the same time, chance to create low-income housing. And it has.

For a release of his liability on the note, the borrower, who was insolvent, agreed to sign it over to the Lowell Development Nominee Trust.

Legal Times
March 21, 1994

DEALS & SUITS

Resolution Trust Corp. v. Diamond, et al.

The Resolution Trust Corp. has won a major victory giving it the power to override state and local rent controls on property taken over by the federal agency.

Reversing a lower-court decision, the U.S. Court of Appeals for the 2nd Circuit on March 2 ruled that the RTC can cancel the leases of tenants in rent-controlled buildings that it has taken over.

The RTC came into conflict with New York state and city rent-control regulations in 1990 when it became responsible for disposing of nine city apartments in a building being converted into a condominium. The titles to the units had been held by a failed thrift.

After the thrift was closed, the RTC notified the tenants that it was repudiating the tenancies. The tenants could leave immediately, stay through the terms of their leases, or purchase their units. The tenants rejected the RTC's offers.

The agency filed suit Feb. 25, 1991, in the U.S. District Court for the Southern District of New York, seeking a ruling that it had the power to cancel the tenancies. The state attorney general and the New York Division of Housing and Community Renewal filed a countercomplaint, contending that the RTC had no statutory authority to evict the tenants.

The District Court denied the RTC's request for summary judgment on Aug. 21, 1992, and granted the state's motion, ruling that the tenancies were not within the scope of the federal statute.

But the three-member 2nd Circuit panel disagreed, concluding that the tenancies were contract-based leaseholds subject to the RTC's authority to cancel.

"Absent any likelihood of predatory behaviour by RTC as receiver or conservator, there was no reason for Congress to restrict the kinds of tenancies subject to its repudiation powers and every reason for Congress to strengthen RTC's hand in remedying a national economic emergency," the court ruled.

For the appeal, the RTC turned to **Abraham Sofaer, Dennis Klein, Laurence Bates,** and associate **Kevin Crotty** of the D.C. office of New York's **Hughes Hubbard & Reed. Frank Penski** of the New York office of Rochester, N.Y.'s **Nixon, Hargrave, Devans & Doyle** argued the case at the lower court.

The RTC also looked to in-housers **E. Glion Curtis,** acting general counsel; **James Barker,** assistant general counsel; **Kevyn Orr,** senior counsel; and to **James Marino, Alan Kucker,** and **Saul Bruh** of New York's **Kucker Krause & Bruh.**

New York relied on state Assistant Attorneys General **Karen Smith** and **Gary Connor.** The Division of Housing and Community Renewal turned to in-housers **Dennis Saffran,** general counsel; **Cullen McVoy,** chief of litigation; and **Richard Hartzman,** associate counsel.

Three groups of tenants tapped **Eli Mattioli** and associate **Douglas Aronin** of New York's **Wien, Malkin & Bettex; Don Buchwald** of New York's **Buchwald & Kaufman;** and **Steven Raison** and **Colleen McGuire,** both New York solo practitioners.

The appeal was heard by Judges Dennis Jacobs, Joseph McLaughlin, and George Pratt; Jacobs wrote the decision.

The state is planning to file a writ of certiorari with the Supreme Court.

—Judy Sarasohn

Homeless finding temporary haven

Complex ready for 30 families

By Ryan Konig
Staff writer

It was once a beacon for drug deals and police sirens. Now it is the home of second chances.

An apartment complex at 1050 W. Mountain View Road that once caused problems for the surrounding community, since has been vacated, sold and converted into a temporary home for homeless families.

The families, up to 30 at a time, will live at the Vista Colina Apartments generally for about two months while they look for jobs and new housing.

The Central Arizona Shelter Services, which runs the homeless shelter at 1209 W. Madison St., recently took over management of the apartment complex.

The Labor's Community Service Agency bought the buildings for $140,000 last month. It is using volunteer labor for the renovation work that will cost about $100,000 in materials.

The Arizona Multibank Community Development Corp., along with Valley National Bank, lent $240,000 needed for the project.

Fifteen families moved into the apartments just before Christmas.

All the project wants now is a stamp of approval from the surrounding community.

Mary Orton, the director of the Central Arizona Shelter Services, has been meeting with north-central Phoenix community leaders as well as residents of the Mountain View Neighborhood, which encompasses the apartment complex.

Many of those she has met with have said they support her project.

Brian McClaskey, a nearby resident, said he isn't surprised by the support. Although many neighborhoods erupt in protest when an agency tries to provide housing for needy people, the Mountain View Neighborhood so far seems to be giving the Central Arizon Shelter Services a chance to make the project work.

"Mary Orton has shown that she and her organization are willing to mitigate the concerns that we have," McClaskey said.

McClaskey started an effort a few months ago to organize the Mountain View Neighborhood of Excellence. He added that the organization will try to get the families in the newly opened apartment complex to participate in the area's improvement programs.

Some of the nearby residents have said they are concerned that the housing program will overcrowd the nearby Mountain View Elementary School. They also are worried that the program's dropouts will be "dumped" into the area.

Orton said those concerns will be taken care of.

Many of the school-age children in the apartments will continue to attend the Accommodation School, a school in central Phoenix that was set up for homeless children. A bus picks up and drops off the children each school day.

Orton said families that don't become self-sufficient before their temporary housing agreement expires will be returned to the downtown shelter.

She added that Sunnyslope families who qualify for the housing program will be given preference

in getting into the apartment complex when vacancies arise.

"If there is a problem now or later, when things really get rolling, we want to know about it," Orton said.

The apartment complex has 35 units. Four will be converted into a child day-care center for resident families. One will be used by the staff, which will be on site 24 hours a day.

The apartments were owned by the federal government after the previous owner went bankrupt. It had been vacant for several months when the Labor's Community Service Agency bought the buildings.

Soon after, the building was leased to CASS.

The Labor's Community Service Agency is a non-profit group that organizes volunteer labor for community projects. In fact, the agency organized the construction of the homeless shelter at 1209 W. Madison.

About 15 to 20 volunteers have been working to renovate Vista Colina Apartments, said Kevin Murphy, the executive director of the agency.

The agency is involved in several community projects, including the housing of 33 homeless families and an effort to rehabilitate about 40 south Phoenix homes of elderly people.

Andrew Gordon, president of the Arizona Multibank Community Develop Corp., said the group was interested in issuing a loan for the complex because it fit in nicely with the corporation's goals.

The community development corporation is a non-profit group funded and supported by 13 Arizona banks. Its goal is to provide financial and technical assistance to programs for affordable housing and economic development.

Wednesday, January 13, 1993 The Arizona Republic/THE PHOENIX GAZETTE

Complex to house homeless

Offers transition to independence

By Ryan Konig
Staff writer

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ARIZONA REPUBLIC 1-10-93

Neighborhood opens its doors to the unwanted

EDITOR'S VIEW

MARY GINDHART

Something's going right in north-central Phoenix neighborhoods.

Other city neighborhoods take note.

Neighborhoods in north-central Phoenix don't have a lot of city-funded crime-prevention programs. They don't have a lot of money to fight blight.

Yet they are closing crack houses, relocating prostitutes and pushing pornography shops to the outskirts of their neighborhoods.

And they even have given the go-ahead to helping the homeless in their neighborhoods.

North-central Phoenix residents are tackling neighborhood problems head on. They aren't waiting for help. And they aren't turning their back to human needs.

In Sunnyslope, a 35-unit apartment complex recently opened its doors to homeless families.

Fanfare has been small. Opposition has been smaller.

So what's the difference between this project and others throughout the city that have faced opposition? Glendale didn't want a Phoenix home for troubled youths in its city. Central Phoenix has tried to keep out group homes for the mentally handicapped.

Some of our Valley's residents seem to make a hobby of fighting each other to keep group homes of one kind or another out of neighborhoods. Neighbors don't want the elderly, the handicapped, the poor

Down the street is bad. Around the corner, in another block, is better. Just not in my back yard.

Trouble is, around each corner is another neighborhood.

Sunnyslope residents aren't wasting time with in fighting and bickering. And these residents met a social need head on — right in their own back yard.

More than 20 families in Sunnyslope's Mountain View Neighborhood have been given a temporary home in a 35-unit apartment building. These families now have a chance to find jobs, secure a permanent living place, send their children to school.

Central Arizona Shelter Services operates the complex so it can be used to house the homeless until families can recover from hardships.

Once a hangout for drug dealers, the Vista Colina Apartments now offer folks a chance.

Brian McClaskey, a nearby resident who started the Mountain View Neighborhood of Excellence, has said his organization will invite the new families to participate in programs to improve the area.

A welcome wagon? What a concept!

The remarkable event here is that not only did people not fight the project, but the project effectively cleaned up apartments which neighbors said were a common site for drug deals.

What's that about killing two birds?

Everyone is pitching in. Valley National Bank loaned $240,000 for the project. Others donated materials for renovation. VNB $100,0 AzNB $140

Just before Christmas, 15 families moved in. Neighbors aren't finger-pointing, shuddering in their shoes or whining about nasty homeless people moving in next door. Theirs is a Good Neighbor policy.

Sunnyslope families who qualify for the housing program will be given preference. Families who don't become self-sufficient will be returned to the city's downtown shelter.

It's a chance.

It could be the chance of a lifetime.

Mary A.M. Gindhart is editor of the North Community section.

Deliver To Guest: LAURA WRIGHT #2052

94 CASS newsletter

Vista Colina: CASS' Family Shelter in North Phoenix

IMAGINE the bewilderment on your children's faces as you tell them that you have to leave your house tonight. Imagine telling them that they can only bring a pillow and a favorite stuffed animal and a small suitcase of clothes. Of course, they can not understand. They don't even know what questions to ask.

Could you tell them that you all will be camping somewhere in the car, or staying in a homeless shelter, until one of your expected sources of help comes through? In a humane community, parents facing economic calamity should have better options than that conversation in their children's room.

A car pulls up to the curb at the CASS shelter and a frightened parent comes inside for help. Children look out the back windows wide-eyed at the men standing on the sidewalk. It would be wrong to call such a moment a normal occurrence, but it is a common occurrence.

If there is room for them (and there is very often not), it would be the usual case for the father to be assigned a bunk in the men's shelter downstairs, and the mother and children to be sheltered upstairs. As if they didn't have enough stress and confusion, they are now separated in a very large and strange building.

In early 1993, something much better happened. With the help of Labor's Community Service Agency, Arizona Multibank Community Development Corporation, Bank One, the J.W. Kieckhefer and Margaret T. Morris Foundations, Catholic Healthcare West, The Phoenix Suns Charities, Gannett Communities Fund, and many individuals, companies and families throughout the community, CASS opened a family shelter in north Phoenix that looks no different from an average apartment building. The family stays together. A kitchen in each unit allows them to prepare their meals and dine together. *For the younger children, they don't even have to know it is any such thing as a homeless shelter.* But it is.

Within the property is a licensed child development center, where the young children receive the highest level of professional care while the parents are looking for work or attending job training. Social case workers are located on the property, and the residents have access to the job developers of the main shelter.

It is called the Vista Colina Family Shelter, and it has made all the difference in the world. As a family's stress level goes down, it becomes possible to solve all kinds of serious problems. The 90-day move out goal for families is realistic, and many move out even sooner, back to a normal life of economic self-sufficiency.

The family-to-family spirit of helpfulness and moral support is the hallmark of Vista Colina (as it also is in the main shelter downtown-- to many people's surprise). In addition to helping each other, every family takes a part in maintaining Vista Colina itself.

It is now possible for some Valley parents in severe economic distress to go to their children's rooms and explain that they have found a special new place where they can live while the family gets started toward a much happier future. That's a conversation you *can* imagine having with your children. Creating positive and imaginable options for each other is what living in a community is all about; we are all responsible for that.

There are no children in the downtown shelter any longer. They are missed by the staff and the elderly residents, but they are much better off where they are now, headed to a much better future.

For each one of the seventy-five children now at Vista Colina, there are perhaps twenty children living in our Valley in cars or in desert camps, and many more, doubled-up in crowded and unhealthful housing. The Valley needs a dozen or more family centers like Vista Colina. CASS's volunteers and staff people are working hard to develop more community financial support -- sometimes one dollar at a time-- to make that happen as soon as possible.

TUESDAY SPECIAL

Valley Interview

From the Pain of the Quake, an Idea for Low-Income Housing

Michael Goodman is a real estate entrepreneur and past president of the nonprofit Organization for the Needs of the Elderly in Van Nuys. He believes the Northridge earthquake may have a silver lining by providing an opportunity to develop more low-income housing in the San Fernando Valley. He was interviewed by Times staff writer **John Johnson.**

Question: *Could you tell me about your idea?*

Answer: First let me give you a little background. There has been almost no affordable low-income housing that has been developed of any significance in the San Fernando Valley for many, many years. And today, the cost of building a new project is not as practical or as feasible as buying something that's existing and rehabilitating it or remodeling it, depending on the degree of fixing up that it needs. Developing new low-income housing requires a fresh approach then.

The opportunity here stems from the fact that even before the earthquake, many apartment building owners were financially strapped, especially if they bought their buildings any time in the last five or six or seven years. Because of what's happened in the real estate market generally, they probably have no equity in their buildings. In many instances, the buildings are worth less than the loans against them.

Owners in this category whose buildings were damaged in the earthquake are not going to be inclined to take money out of their pockets to repair a building that they're either not making money on or they have no equity in. So, they're more than likely going to say, "I'm going to let go of this building."

Q. *What happens then?*

A. They are basically going to give the buildings back to lenders. It's my feeling that now is a time that perhaps we can begin to meet some of the housing demand in the Valley by rehabilitating these buildings and converting them to low-income and affordable housing.

In order to do that, though, there has to be a spirit of cooperation existing between the city, between the lending institutions and between the development community.

Q. *Who would take the lead on this? How would this work?*

A. My feeling is that the lead has to be taken by the City Council people whose districts were affected by the quake and by the financial institutions to work with not only the cities, but also the people who would be providing the housing. It could be nonprofit, could be for profit or maybe combinations of the two of them working in concert.

I'm not suggesting by the way that all of the available housing stock in terms of apartment buildings is going to fall into a category where it is either appropriate, or even desirable, to do something like this. What I am suggesting is, if we are all interested in seeing some changes take place, then some percentage, maybe it's 10%, maybe it's 5%, maybe it's 15% of the units, could be used this way. I think we could conceivably be talking in terms of 1,000 units that could fall into this category.

Q. *Would the city buy up all these buildings and operate them through some authority?*

A. I don't think that's going to happen. First of all, they're not in a financial position to be able to do that. Nor is it necessarily the most desirable thing to happen. The way it might work is that people willing to buy these buildings and rehabilitate them would be able to take the buildings off the banks' hands at a reduced price in return for a promise to operate them afterward as affordable housing. What the city can offer is ways of expediting the processes that are necessary in order for the rehab work to be completed. They can provide what they call gap financing to do this rehab work. They can consider waiving, or deferring, certain fees. In other words, they can provide an environment that would allow for this to happen.

Q. *Would there be some authority controlling the program?*

A. There are lots of authorities already in place that under any circumstances would have either a direct or peripheral involvement. The management of the projects may be done either by nonprofit or for-profit operations, depending on who's involved. There may also be different types of projects done. Some of them may be purely rental. Others might be ones where there is a form of ownership created, as in a

cooperative form of ownership, where you would end up creating something where the people that live there now become stakeholders in the community.

Q. *If some structure is set up where fees are waived and everybody comes together to make this happen, wouldn't you need some sort of binding agreement such that people who benefit from all these favors don't get in there and increase the rents later on?*

A. These favors are not going to be allowed unless they're conditioned on certain requirements that housing be maintained under a certain rental level, generally the life of the building or very long-term. Because the idea with this is to create a sort of a pool of affordable and low-income housing that will continue to be there

in 10 years and 20 years from today. Part of the coming together of this is for people not to have a new vehicle to take advantage of the system. That's not to say that there may not be an opportunity for people to make money in that.

Q. *Do you have any sense so far of how many units have been turned in?*

A. I can't give you specific numbers, but I'm hearing that a lot of owners are desperately seeking solutions of what to do.

Q. *The way you've mapped this out, this might benefit people who don't turn their buildings in, who say: "I'm going to have to turn my building in unless something is done," and then this organization could help?*

A. That's true. That may happen. I don't want to suggest that it's an organization that's going to do this, because God knows we don't need another organization to be created to do something. There are enough organizations out there, both private and public, to be involved in this process.

What has to happen, though, is a desire for these different groups to be participating—for somebody to come forward and say: "Hey, we really want this to happen." It may happen from a City Council person saying, "I am strongly supportive of something happening in my community that will address these needs. Therefore, I am going to designate someone on my staff to help coordinate this effort, working with groups to see that we can move this through the system. We are going to work with already existing agencies in the community. We are going to work with developers and streamline this process."

Q. *Have you talked to any City Council people?*

A. The only one that I have spoken to in this regard is Laura Chick, who is very supportive of this h...

brought together a number of different groups representative in the community of the people we are talking about to have discussions about how to address this both short-term and long-term.

You also have to have a lender out there that has sort of an enlightened executive, who says: "Hey, you know what? Part of our community reinvestment, part of our long-range plan in the community, is to see to it that worthwhile projects are done to better enhance the community. Okay, we've got some buildings, or we know we're getting some buildings back. We want to participate in something like this."

Q. *How needed is this? Before the earthquake, if you drove around the Valley and you looked at apartment buildings, you saw signs reading "First month free, free move-in, no deposits." It seemed that there was already pressure downward on rents because there was an abundance of rental units out there.*

A. That's true. But that doesn't necessarily mean that that is addressing the needs of a family where you have two parents or a single parent, where you're talking about people working at a minimum wage. It doesn't mean that we're addressing the needs of an elderly widow or widower who has a very minimal amount of money coming in.

In order to pay the rent, for instance, a lot of lower-income families are having to double up. They're doubling and tripling up in small units because that's the only way that they can pay rent.

So what we're talking about here is, how can we make a dent in the need and the demand that is out there without having to develop new housing? Which is economically not that viable when you have existing housing out there that can be bought for half the price that it would take to develop the same thing new to-

FRIED, FRANK, HARRIS, SHRIVER & JACOBSON

THE HONORABLE CHRISTOPHER J. DODD
CHAIRMAN, SECURITIES SUBCOMMITTEE OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Re: The Supreme Court's Recent *Central Bank of Denver* Decision

Dear Mr. Chairman:

I am pleased to respond to your letter of May 11, 1994, in your capacity as Chairman of the Securities Subcommittee, requesting my views, for the record, on the implications of the Supreme Court's recent *Central Bank of Denver* decision,[1] and seeking any recommendations I might have on how Congress might respond to that decision.[2] Your request is in anticipation of hearings the Securities Subcommittee will be holding this afternoon. In order to enable you to submit these views for the record, I have complied with your request to furnish you with my response prior to the opening of the hearing. If you should desire more elaboration on any of the issues discussed below, or would like me to address additional issues, however, I hope you and the Subcommittee will not hesitate to contact me.

Preliminary Personal Statement

At the outset, I should like to address the context in which this response is submitted. As you know, I had the privilege of serving for more than a decade as a member of the Staff of the Securities and Exchange Commission, and from 1975 to 1978 as the Commission's General Counsel. Since September 1978, I have been a partner in the law firm of Fried, Frank, Harris, Shriver & Jacobson, and I am currently resident in the Firm's New York and Washington, D.C. offices.[3] At the present time, I am also serving as the Co-Chair of a Task Force of the American Bar Association's Business Law Committee on Joint and Several Liability under the Federal Securities Laws.

Although I represent various clients who, from time to time, might have an interest in the subject matter of your hearings, I have always maintained a policy that any views I express to the Congress are solely my own. This letter, therefore, has been prepared directly by me, and reflects only my personal views. It does not reflect the views of any client of my law firm, and I have not been compensated by anyone (directly or indirectly) to prepare this letter, or to articulate the views it contains.[4] This letter also does not reflect the official views of the American Bar Association, or its Business Law Committee, or the Task Force that I co-chair. Indeed, except for two colleagues, who have assisted me in putting this letter together, you are the first person who will be receiving or reading its contents. While I know that this may not be critical in assessing the views that follow, I deem it important to let you know that you are receiving only my personal views.

The Operative Context

Without unduly belaboring the obvious, the *Central Bank* decision should be considered in context. Although the Federal securities laws, and particularly the Securities Exchange Act, have been reviewed periodically by Congress, and frequently updated, there has never been a comprehensive Congressional review of the phenomenon of private litigation under the Federal securities laws.[5] Private litigation is critical to the effectiveness of the Federal securities laws. Despite some difficulties that have arisen over the years, private rights of action have served two valuable public policies—first, private rights serve as a "necessary supplement" to the Com-

[1] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*, 62 U.S.L.W. 4230 (April 19, 1994).

[2] A copy of your letter is annexed as Exhibit A.

[3] A copy of a brief resumé is annexed as Exhibit B.

[4] My clients are aware that I frequently write, lecture, or testify on issues of importance in corporate and securities laws, and they understand that in expressing my own views, I may articulate positions that are not supportive of positions they might wish me to espouse as a paid advocate.

[5] The American Law Institute, of which I am a member, commissioned a review of the Federal securities laws under the aegis of Louis Loss, then a distinguished professor of law at Harvard Law School, and a former Commission alumnus. Congress has engaged in two major legislative revisions of the Securities Exchange Act—in 1964, and in 1975—as well as numerous other efforts designed to deal with specific problems over the sixty-one years since the first of the Federal securities laws was enacted.

mission's own enforcement actions;[6] and second, private litigation serves to ensure the confidence of public investors, and particularly individual investors, that our capital markets are fair and that misconduct can effectively be redressed and encourages them to invest with confidence.[7]

The legislative approach to private securities law remedies adopted in 1933 and 1934 was thoughtful and balanced, but appears today to be under-inclusive. No one could then have predicted the exponential growth we have witnessed in our capital markets. And, although the Acts were adopted with a view to stem abuse in our capital markets, no one could then have prophesied the myriad ways in which investors could become victims of those with nefarious ulterior motives. Nor could anyone then have anticipated the development of new forms of investments, innovative methods of trading and novel forms of communication among an ever-expanding universe of market participants.

The Commission has been a vigilant watchdog of shareholder rights, and has developed what most would concede is one of the finest—if not the finest of—enforcement programs in Government, but the agency is limited in what it can do. And, the express remedies provided by the Federal securities laws long ago proved inadequate to cover many types of fraud, particularly in the secondary trading markets.[8] Because of these difficulties, Federal courts were besieged, early on in the administration of these statutes, with requests that they imply private causes of action. While this effort was well-motivated, it progressed without real guidance from Congress, and without paying the same meticulous attention to a balancing of competing interests that marked the efforts of Congress in the express remedy provisions of the Securities and Securities Exchange Acts.[9]

The result has been a significant perversion of the purposes private litigation is intended to serve. While many private actions are meritorious, and do not raise the problems discussed below, many of the private lawsuits that are filed, rather than reflecting a fair effort to redress appropriate concerns, reflect efforts by plaintiffs' attorneys seeking to find some deep-pocketed defendant to hold responsible either for the legitimately questionable acts of impecunious principals, or to compensate someone for a drop in the market price of securities. These lawsuits are filed without any real investigation, hurling accusations and charges that are unsupported, and frequently unsupportable. The targets of these lawsuits are selected, in far too many instances, not because they have engaged in improper conduct, but because they are financially capable of settling the action on meaningful terms—at least in the eyes of the plaintiffs' lawyers, who often are the principal, if not the exclusive, beneficiaries of such litigious efforts.[10] As a counselor to public companies and securities professionals (such as accounting firms, law firms, and broker-dealers), I have often seen clients compelled to weigh, and reluctantly accept, a settlement of ill-conceived litigation because the cost and vicissitudes of litigation create too much of a risk for shareholders.

In essence, much of this private litigation has seen a reallocation of corporate assets, when corporations bear the burden of a settlement. Present shareholders are deprived of company assets in favor mostly of plaintiffs' lawyers, who often are compensated far more generously than those on whose behalf they purportedly institute suit. When the defendants are securities professionals, the difficulties become even more severe. An accounting firm that may have received hundreds of thousands of dollars in fees for an audit, can somehow be held liable for tens of millions of dollars because they, too, like the subject company's shareholders, were victimized by some malevolent individuals. Primary wrongdoers settle quickly, and cheaply, leaving securities professionals to defend themselves, and pay the tab in the event a Federal court invents a theory of liability that a jury may be all too willing to apply to professionals they assume are well-capitalized, or well-insured.

This phenomenon is not new, nor has it not gone unnoticed. Nearly two decades ago, the Supreme Court warned that private securities litigation could be far more

[6] *See, e.g., J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

[7] *See* Arthur Levitt, Private Litigation under the Federal Securities Laws, Address before the Securities Regulation Institute (Jan. 26, 1994) at 1.

[8] Section 18 of the Securities Exchange Act is a good example. It permits investors to pursue false statements made in any document filed with the Commission. But it does not cover false statements made in the press; or to other agencies of Government, or in face-to-face transactions, or in exchange or over-the-counter transactions. This accounts for the paucity of actions that have ever been brought under this statute.

[9] Without meaning to be critical, there is a vast difference between considered legislative judgments about general statutory requirements and the efforts of a court to promote rough justice between the litigants before it. The latter is no substitute for the former.

[10] Anthony Borden, *The Shareholder Suit Charade*, AMER. LAWYER, Dec. 1989, at 67.

abusive than other types of litigation.[11] Similarly, as the then General Counsel of the Commission, expressing only my own personal views, I publicly questioned the excesses of private litigation, and pointed out some of the deleterious effects it could have on the Commission's own enforcement of the Federal securities laws.[12] Those concerns have not been widely heeded, and the lower courts have continued to devise new causes of action in the absence of Congressional action.

As pointed out in your letter, *Central Bank* is one of the most significant Federal securities law decisions in many years. The Supreme Court's decision rejected any implied action under Securities Exchange Act Rule 10b–5 for aiding and abetting. Your immediate attention to this issue is a testament to the Court's view that Congress knows how to impose aiding and abetting liability when it chooses to do so. A thorough examination of how the decision will impact the current system of securities litigation is an essential step toward making that choice. After outlining the impact I believe *Central Bank* will have on the Commission, investors and professionals who have been charged as aiders and abetters, this letter sets forth my views regarding how Congress might respond to the decision.

The Decision's Significance

On May 2, 1994, the NEW YORK LAW JOURNAL published an article I had prepared, analyzing the implications of the *Central Bank* decision.[13] Because I have included a copy of that article with this letter, I will not here repeat all of the points I raised in that article. Instead, I will summarize some of the more salient implications I believe will be engendered by the decision, as well as some additional thoughts I have had since that article was prepared.

IMPLICATIONS FOR THE SEC

Despite recent assertions to the contrary,[14] I do not believe it is open to question that the *Central Bank* decision will preclude the SEC from imposing Rule 10b–5 aiding and abetting liability. This conclusion, endorsed by the dissent,[15] flows from the fact that the decision interprets statutory language, not legislative policy.[16] In future SEC cases, a section-by-section approach to civil aiding and abetting liability will apply. The Court expressly noted, for example, that the "SEC may proceed against brokers and dealers who aid and abet a violation of the securities laws . . . ."[17] The constraints imposed by the Court on aiding and abetting liability should not be restricted to Rule 10b–5. The Court's analysis would seem to apply to all the statutory provisions administered by the Commission. Even where the Commission does have the authority to pursue securities professionals on theories of aiding and abetting, such as in the case of broker-dealers, the Commission will be required to show first, that a primary violation of law occurred, and second, that the broker-dealer's conduct was "willful." Based upon recent Supreme Court decisions, the "willful" standard requires proof of deliberate misconduct.[18]

The SEC should be able to rely on its 1990 powers to impose cease-and-desist orders, along with certain forms of prophylactic relief, to recapture some causes of action it has lost by virtue of the demise of aiding and abetting liability. The 1990 amendments permit the SEC to proceed administratively against persons who "cause" another person's violation of the Federal securities laws. While this cease-and-desist power is not coextensive with the scope of true aiding and abetting liability, it would enable the Commission to pursue persons who, albeit not primary wrongdoers, took deliberate and *affirmative* steps to cause another person's violation of the law. In my view, the decision will place a heavier burden on the Commission to initiate its own enforcement actions, rather than to rely on private litigation, in light of the fact that certain conduct may not be redressable by private parties, but may be reachable by the Commission in an administrative forum.

Perhaps the most significant implication for the Commission is the fact that it is laboring under a statute—Section 10(b) of the Securities Exchange Act—and a rule—Rule 10b–5—that are ill-defined, and ill-suited to accomplish their intended

[11] *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

[12] Harvey L. Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 SECUR. REG. L.J. 3 (1977).

[13] Harvey L. Pitt, *The Demise of Implied Aiding and Abetting Liability*, NATIONAL L.J., May 2, 1994, at 1. A copy of my client memorandum, which served as the basis for that article, is annexed as Exhibit C.

[14] Sharon Walsh, *High Court Ruling Sharply Curbs Suits on Securities Fraud*, N.Y. TIMES, April 20, 1994, at A-1.

[15] 62 U.S.L.W. at 4240 (Stevens, J., *dissenting*).

[16] *See Aaron* v. *SEC*, 446 U.S. 680 (1989).

[17] 62 U.S.L.W. at 4235.

[18] *See Ratzlaf* v. *United States*, 114 S. Ct. 655 (1994); *Hazen Paper Co.* v. *Biggins*, 113 S. Ct. 1701 (1993).

remedial results, particularly with respect to insider trading violations, but also with respect to violations occurring in connection with press releases, financial statements and the like. The need for a comprehensive legislative solution to the problem of private litigation, and the reach of Rule 10b–5 is manifest, and even the SEC has recognized that at various points in the past, at least with respect to some aspects of the Section and Rule's coverage.[19] In the absence of some legislative help, the SEC continues to face the possibility that private litigants, seeking to stretch the laws beyond their legitimate contours, may cause significant damage to the Commission's own flexible approach to the interpretation of the Federal securities laws.

IMPLICATIONS FOR INVESTORS

On the day after *Central Bank* was decided, front-page newspaper headlines heralded the erosion of investor recourse to private rights of action.[20] I urge you to look beyond those initial headlines. *Central Bank* addressed only a sliver of a system of securities litigation which, viewed as a whole, has served investor interests poorly. I see this in several aspects of my practice.

Most importantly, investors of a public company mired in shareholder litigation find they must pay not once, nor twice, but three times to extract the company from this quagmire. First, it is the shareholders who, ultimately, bear the cost of the company's defense. And *Central Bank* underscored, yet again, that "'litigation under Rule 10b–5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general.'"[21] Second, the typical case ends in settlement and, again, *all* the company's shareholders bear the burden for creating a fund to compensate plaintiffs' counsel with the residual going to a subset of the company's investors. Finally, the costs of the litigation linger in increased insurance premiums for director and officer liability. While your Committee inevitably will be presented with conflicting data about the relative efficiency of this litigation, there can be no debate about who, in the end, must pay the tab.

In addition, shareholder litigation serves to constrict the flow of information to investors. In a National Investor Relations Institute survey of 386 corporate officers responsible for investors communications, half the respondents reported that they were under pressure from legal counsel and senior management to reduce the level of voluntary disclosure out of concern for shareholder litigation. Forty percent said they had bowed to such pressure.[22] Although the SEC has crafted a safe harbor for projections,[23] I personally counsel against companies making projections because they are fodder for shareholder litigation.[24] Our present system of shareholder litigation, therefore, prompts companies to limit disclosure of the very information that investors need most.

Moreover, given the greater exposure of officers and directors to individual liability, many corporations are finding it difficult to attract qualified individuals to serve as officers and directors.[25] And, even when companies are fortunate to find qualified persons to serve, directors must spend a great deal of their time worrying about the consequences of a marketplace they barely understand, and cannot control. The knowledge that anything they do may trigger a reduction in the price of the company's securities has a stultifying effect on corporate decisionmaking, and often creates a barrier to precisely the types of creative corporate governance, and candid disclosures, the SEC seeks to encourage.

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[19] As you may be aware, in 1987, I was asked by this Subcommittee to chair an ad-hoc committee of private attorneys charged with the task of defining the crime of insider trading. The result of our efforts was in the form of legislation by Senators Riegle and D'Amato, and the concept of that legislation was endorsed by the SEC.

[20] *See, e.g.*, Sharon Walsh, *Supreme Court Limits Whom Defrauded Investors Can Sue*, WASH. POST, April 20, 1994, at A–1. Linda Greenhouse, *High Court Ruling Sharply Curbs Suits on Securities Fraud*, N.Y. TIMES, April 20, 1994, at A–1.

[21] 62 U.S.L.W. at 4237 (quoting *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739 (1975)).

[22] *See*, Louis M. Thompson, President, National Investor Relations Institute, Shareholder Litigation and Corporate Disclosure: A Conflict with a Resolution, Address before the American Stock Exchange CEO Regional Program.

[23] 17 C.F.R. § 230.175 (1993).

[24] *See* Harvey L. Pitt & Karl A. Groskaufmanis, *Shareholder Suits Suggest Some Lessons*, NATIONAL L.J., Aug. 10, 1992, at 24.

[25] In the mid 1980's, Armada Corporation, a Detroit-based manufacturer of alloys and exhaust systems, declined to renew its directors and officers liability insurance when the premiums increased tenfold. When most of the existing board resigned, Armada President Jerry Luptak replaced them with "low-net-worth people" whom the company could afford to indemnify against liability. *See* Lewin, *Director Insurance Drying Up*, N.Y. TIMES, March 7, 1986 at D1.

Another important implication for investors of the *Central Bank* decision may be a reversal of what has been a troubling trend. The potential of shareholder litigation, with its uncertain capacity for the imposition of liabilities to an indeterminate class, for an indefinite amount of money, has discouraged many professional firms from providing services to smaller companies, particularly in the high technology areas.[26] This facet of the current litigation system did not escape the Supreme Court's attention.

The *Central Bank* decision limits only one aspect of a system of securities litigation under which investors fare poorly. A patchwork solution will not redress these shortcomings. Investors would be served best by a comprehensive response that preserves recourse to the judicial system for those with legitimate claims while containing the abuses which, in the end, are borne by investors.

IMPLICATIONS FOR SECURITIES PROFESSIONALS

The Court's decision should emancipate peripheral defendants from liability in actions under provisions of the Federal securities laws other than Rule 10b–5. While the decision deals only with Rule 10b–5, its logic would extend not only to implied rights of action under the proxy rules (and, in particular, SEC Rule 14a–9), but also to each of the express remedy provisions of the Securities Act and the Securities Exchange Act, since the Court found that those provisions expressly do not reach aiding and abetting liability. *Central Bank* may not provide as much respite for professionals and other deep-pocketed peripheral defendants as hoped, however, since private parties can be expected to cloak charges of aiding and abetting in the guise of primary violations of law. It remains to be seen whether the courts will prove receptive, as they should, to motions to dismiss on the ground that the substance of an allegation is nothing more than a cleverly concealed charge of aiding and abetting.

The *Central Bank* decision presages the potential demise of *respondeat superior* and other forms of non-statutory vicarious liability for brokerage firms and others under the Federal securities laws. In the absence of express authorization for such liability, the Court's decision makes it unlikely that it would countenance the implication of such liability in the context of implied actions under Rule 10b–5. The fact that § 20(a) of the Securities Exchange Act specifically contemplates controlling person liability, and establishes clear standards for its invocation, suggests that all other forms of vicarious liability will not be tolerated under Rule 10b–5.

In rejecting the SEC's argument that the Federal criminal aiding and abetting liability statute[27] was an appropriate predicate for implying civil aiding and abetting liability under the Federal securities laws, the Court hinted at the possibility that "recklessness, . . . [as opposed to] intentional wrongdoing" would not be an acceptable basis for imposing liability.[28] The Court never reached the issue squarely in *Central Bank*, but the tenor of the decision, and some of its language, suggests that even where aiding and abetting liability can be pursued by the SEC, the appropriate standard of liability will be intentional wrongdoing.

Although the Court acknowledged that secondary actors in the securities markets will not "always [be] free from liability under the securities Acts," it articulated a threshold burden for the SEC and private parties to meet:

> [a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming all of the requirements for primary liability under Rule 10b–5 are met.[29]

How Congress Might Respond

The question whether aiding and abetting is to be expressly included within Rule 10b–5 should not be answered in isolation, or in the context of unrelated legislation. Instead, the question is more appropriately addressed in the context of answering the broader question of how securities litigation should be reformed. The perils of addressing aspects of Rule 10b–5 private actions in piecemeal fashion are illustrated by the litigation arising in the wake of Congress' adoption in 1991 of Section 27A of the Securities Exchange Act.

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[26] *A Disproportionate Burden of Liability,* a White Paper responding to the request for data sent by SEC Chief Accountant Walter P. Schuetze to Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick and Price Waterhouse (June 1993).

[27] 18 U.S.C. § 2 (1988).

[28] 62 U.S.L.W. at 4237.

[29] 62 U.S.L.W. at 4237–38.

At the time Section 27A was under consideration, I was privileged to testify before this Subcommittee, and I urged that piecemeal approaches to litigation not be adopted.[30] While my views were given cordial attention, they did not prevail; since then, there have been any number of cases challenging the constitutionality of that effort, including a case currently pending before the Supreme Court.[31] Although I have doubts whether it is necessary to address the implications of the *Central Bank* decision, if this Subcommittee were to reach a different conclusion, I believe that any legislative actions regarding aiding and abetting in Rule 10b–5 actions should be incorporated into, and considered simultaneously with, the Private Securities Litigation Reform Act of 1994, S. 1976.

To be clear, I strongly endorse the thrust and substance of S. 1976, and believe that legislation in substantially that form should be enacted. It is exactly the type of legislation that I believe this Subcommittee should pursue, and it is responsive to the precise concerns of the Supreme Court that fostered the decision in the *Central Bank* case, and that produced so many of the opinions of the 1970's that curtailed the excesses of private securities litigation.

Since receiving your letter, I have briefly reviewed Senator Metzenbaum's proposal, which as I understand it is *not* proposed as an amendment to S. 1976, a bill that does address litigation reform in comprehensive fashion, but rather is a proposed amendment to S. 1963, a bill that addresses interstate banking and branching. While I recognize and applaud the desire underlying the proposal to be responsive to the Supreme Court's importunings that Congress review and address the phenomenon of shareholder litigation, I am concerned that this proposal would not accomplish that goal, and would ultimately disserve the very ends appropriate legislation correctly should seek to achieve.

First, and foremost, I am troubled by any effort to deal with a complex subject, by amending a detailed piece of legislation that addresses a wholly unrelated subject. That type of diversion of effort is certain to produce a less thoughtful approach to any legislation than would be the case if the effort to deal with the *Central Bank* decision were incorporated into S. 1976. This does not mean, however, that I believe there is any need to respond to *Central Bank's* holding apart from the comprehensive approach to secondary liability set forth in S. 1976.

Second, although this proposal attempts to make express what currently is an implied private right of action under Securities Exchange Act Section 10(b), a goal that might be worthy of pursuit in the context of broader securities litigation reform, the bill would send into turmoil decades of legal precedent refining private actions under Section 10(b) and Rule 10b–5. Thus, the bill would modify *both* Sections 10(a) *and* 10(b) of the Securities Exchange Act, by making it "an unlawful act, for which a person may be held liable in an action brought by the Commission or by *any* person" to effect certain short sales or to use or employ any manipulative or deceptive device or contrivance, all in contravention of Commission rules.

1. I do not know why there is any desire to create an express cause of action for certain types of short sales, but I am doubtful that there is any need for such legislation. Nothing in the *Central Bank* decision implicates in the least anything about the need for a private remedy for improper short sales and, to my knowledge, there has never been any significant call for such a remedy. This unusual feature of the legislation does not seem justified by anything of which I am aware, and could create significant issues in the Commission's administration of the Federal securities laws.

2. Notwithstanding the apparent desire underlying the proposal to clarify the law by making a cause of action under Section 10 express, this draft language does not contain the barest rudiments of the cause of action intended to be created, as is the case in each of the other express remedies under the Securities Exchange Act.

3. The proposal purports to create a cause of action on behalf of "any person," an unfortunate formulation that arguably would allow persons who had nothing to do with the defendant, and persons who never purchased or sold the securities affected by the alleged fraud, to maintain a lawsuit. In each of the express remedies under the Act, a plaintiff in a private action must have bought or sold securities from the defendant in order to have standing to sue. The same standard has been implied by the Supreme Court under Section 10(b) and Rule 10b–5.[32]

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[30] Written Submission of Harvey L. Pitt before the Securities Subcommittee of the Senate Banking, Housing, and Urban Affairs Committee Regarding the Bryan Amendment to S. 543, the Senate Banking Bill (Oct. 2, 1991), annexed as Exhibit D.

[31] *Morgan Stanley & Co., Inc.* v. *Pacific Mutual Life Insurance Co.*, Dkt. No. 93–609.

[32] *See Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

4. The concept that a defendant under the proposal may be held "liable" raises a significant series of issues, including whether the Commission's remedies would be expanded by this bill to include liability for damages to private parties. Moreover, the concept of liability is in no way delimited by this proposal, so that it could yield an indeterminate amount of liability to an indefinite number of persons, exactly the problems that have engendered the need for S. 1976.

5. The proposal's inclusion of a cause of action against anyone who might "aid and abet the use or employ of any manipulative or deceptive device or contrivance" is significantly different from aiding and abetting language already present in other sections of the Federal securities laws. The disparity in language raises interpretive questions that could spawn decades of litigation.

6. Moreover, expanding the remedies available to the Commission for seeking injunctions expressly to include aiding and abetting, which by itself is one step removed from the primary securities law violation, and then even farther to reach a person otherwise not regulated by the Commission whom the Commission believes "is about to aid, abet, counsel, command, induce, or procure such a violation" would extend the Commission's current authority in unfathomable ways. At a minimum, the provision—as drafted—raises Constitutional concerns with respect to the right to advice of counsel and freedom of speech.

Given more time to analyze the provision, I expect additional implications of the bill would become apparent. In my view, the ubiquitous litigation over the retroactivity requirement of Securities Exchange Act Section 27A would pale in comparison to the litigation this bill would propagate.

* * *

In sum, I believe that this Subcommittee is already embarked on precisely the effort the Supreme Court recommended in its *Central Bank* decision, and that effort—S. 1976—will produce a reasoned, omnibus, comprehensive piece of Congressional legislation addressing private securities litigation reform. I believe that S. 1976 is the appropriate vehicle for that reform, and that as Congress considers the Supreme Court's latest pronouncement, it should avoid a piecemeal solution to a thorny problem. The proposal put forward by Senator Metzenbaum is well-intended, but I believe it would fall victim to precisely the evils I have described, and that S. 1976 is designed to avoid.

I hope the foregoing has been useful to the Subcommittee. As I indicated at the outset, I remain ready to respond to any additional inquiries the Subcommittee or its Staff may have.

Sincerely,

Harvey L. Pitt

ATTACHMENT A

A

United States Senate

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510-6075

May 11, 1994

Harvey L. Pitt
Fried, Frank, Harris, Shriver & Jacobson
1001 Pennsylvania Ave, N.W.
Washington, D.C. 20004

Dear Harvey:

On Thursday, May 12, 1994, the Senate Subcommittee on Securities will holding a hearing to examine the impact of the United States Supreme Court's recent decision in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.

As you know, in one of the more significant federal securities law decisions in several years, the U.S. Supreme Court held, by a 5-4 vote, that there is no private liability under the federal securities laws for those who "aid and abet" violations of the anti-fraud provisions of the securities laws.

Writing for the majority, Justice Kennedy wrote:

> "to be sure, aiding and abetting a wrongdoer ought to be actionable in certain instances.... The issue, however, is not whether imposing private civil liability on aiders and abettors is good policy, but whether aiding and abetting is covered by the statute."

The hearing will help the Subcommittee determine "whether imposing private civil liability on aiders and abettors is good policy," and assess the implications of the Court's decision for (i) conduct which may be harmful to integrity of the capital markets; (ii) defrauded investors seeking to recover from those who are involved in wrongdoing; and (iii) the SEC's enforcement program. The Subcommittee will also examine ways in which Congress or the courts might respond to the Central Bank decision.

The Subcommittee would appreciate receiving your views for the record on the implications of the Central Bank decision, particularly its

impact on the SEC, on investors, and on professionals who have been charged as aiders and abettors. The Subcommittee is also interested in your recommendations on how the Congress might respond to the decision and specifically what such a legislative response might contain. One proposal has already been put forward by Senator Howard Metzenbaum and is attached for your review. The Subcommittee would welcome your comments on this legislation and whether you believe it is a sufficient or appropriate response to the Central Bank decision.

If possible, I would ask that you provide your views prior to the start of the hearing at 2:30 pm, on May 12, 1994, so that I might submit them for the record during the hearing. If you have any questions about this request, please contact Courtney Ward, George Kramer or Sheila Duffy of the Subcommittee staff at (202) 224-7391.

Thank you very much for your assistance. We look forward to receiving your thoughts on this important matter.

Sincerely yours,

Chris Dodd

Christopher J. Dodd
Chairman
Securities Subcommittee

Attachment

AMENDMENT NO. ____ Calendar No. ____

Purpose: To amend the Securities Exchange Act of 1934.

IN THE SENATE OF THE UNITED STATES—103d Cong., 2d Sess.

S. 1963

To permit certain financial institutions to engage in interstate banking and branching.

Referred to the Committee on ______________________ and ordered to be printed

Ordered to lie on the table and to be printed

AMENDMENT intended to be proposed by Mr. METZENBAUM

Viz:

On page 26, after line 18, add the following new section:

SEC. 8. AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934.

(a) AMENDMENT TO SECTION 10.—Section 10 of the Securities Exchange Act of 1934 (15 U.S.C. 78j) is amended—

(1) by striking "unlawful" and inserting "an unlawful act, for which a person may be held liable in an action brought by the Commission or by any person,", and

(2) in paragraph (b), by inserting ", or to aid and abet the use or employ of any manipulative or deceptive device or contrivance," before "in contravention".

(b) AMENDMENT TO SECTION 21.—Section 21(d)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)(1)) is amended by inserting "or that any person has aided, abetted, counseled, commanded, induced, or procured, is aiding, abetting, counseling, commanding, inducing, or procuring, or is about to aid, abet, counsel, command, induce, or procure such a violation," before "it may in its discretion".

ATTACHMENT B

HARVEY L. PITT

PARTNER, FRIED, FRANK, HARRIS, SHRIVER & JACOBSON

Formerly, *General Counsel,* United States Securities and Exchange Commission (1975–1978); Executive Assistant to Securities and Exchange Commission Chairman Ray Garrett, Jr.; Chief Counsel, Division of Market Regulation of the Securities and Exchange Commission; Editor, Securities and Exchange Commission, *Institutional Investor Report;* Special Counsel, Office of the General Counsel of the Securities and Exchange Commission; Legal Assistant to Commissioner Francis M. Wheat.

Member, *New York Stock Exchange Legal Advisory Committee;* Co-Chairman, *Task Force on Rule 10b–5 Joint and Several Liability,* American Bar Association, Business Section; Advisor, American Law Institute *Project on the Restatement of the Law of Corporate Governance;* Member, Advisory Subcommittee, Federal Regulation of Securities Committee, American Bar Association, Business Section; Member, Executive Council, Federal Bar Association; Co-Chairman, Practising Law Institute, *Annual Institute on Securities Regulation;* Member, Executive Committee and Advisory Board of the Securities Regulation Institute of the University of California; Co-Author, Seven Volume Treatise on *The Law of Financial Services;* Recipient, Institute for Human Relations, Judge Learned Hand Human Relations Award (1988); Recipient, Securities and Exchange Commission, Distinguished Service Award (1977); Recipient, Federal Bar Association, Outstanding Younger Federal Lawyer Award (1975).

Thomas O'Boyle Distinguished Visiting Practitioner, University of Pennsylvania Law School (Spring, 1984); Adjunct Professor of Law, Georgetown University Law Center (1975–1984); Adjunct Professor of Law, George Washington University School of Law.

Former Chairman, United States Senate Securities Subcommittee *Ad Hoc Panel of Lawyers to Define Insider Trading (1987–1988); Former Chairman, Subcommittee on State Takeover Laws, American Bar Business Section (1984–1987); Former Chairman, Subcommittee on Civil Liabilities and SEC Practice, American Bar Association Business Section (1983–1992); Former Public Member, United States Administrative Conference (1984–1987).*

Frequent speaker and author of articles on corporate, Federal securities and banking laws.

ATTACHMENT C

TO OUR CLIENTS

OF DEEP POCKETS, FRIVOLOUS PREMISES AND STATUTORY MAKEWEIGHTS: THE DEMISE OF IMPLIED FEDERAL SECURITIES LAW AIDING AND ABETTING LIABILITY

Elizabeth Janeway noted how galling an idea that will not go away can be, a singularly apt aphorism for abusive class actions against deep-pocketed securities professionals, often sued *not* for what they did, but for what their clients did or the size of their insurance policies. Lower courts tolerated private party pursuit of those whose involvement in alleged frauds was passive at most. The resulting litigation reform pleas were met with skepticism, despite the Supreme Court's observation two decades ago that private securities litigation is uncommonly abusive.[1] For those not listening, the Court's *Central Bank* decision ensures their attention now.[2] It resurrects seasoned themes,[3] and vetoes actions for aiding and abetting Rule 10b–5 fraud; most notably, it charts a path for resolving future securities law controversies.

Background

Central Bank, trustee for two bond issues to finance public improvements to a planned community, agreed to secure the bonds by land appraised at values of at least 160 percent of outstanding principal and interest. Before the second offering, a new appraisal ascribed almost the same values as the original appraisal for the

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[1] *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 740–41 (1975).

[2] *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.,* 62 U.S.L.W. 4230 (April 19, 1994).

[3] *See, e.g., Santa Fe Indus., Inc.* v. *Green,* 430 U.S. 462 (1977); *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976); *Aaron* v. *SEC,* 446 U.S. 680 (1980); *Chiarella* v. *United States,* 445 U.S. 680 (1980). Curiously, these theses have been missing from the Court's more recent decisions. *See, e.g., Virginia Bankshares, Inc.* v. *Sandberg,* 111 S. Ct. 2749 (1991).

land securing the first offering, despite significant local real estate declines. The lead underwriter conveyed concerns that the 160 percent test was not being met; *Central Bank* sought an independent review of the new appraisal, but it deferred the review until *after* the second bond offering, once the second appraiser said additional information supported his conclusions, and the developer pledged another $2 million in collateral. The second offering defaulted 2 years later; First Interstate, a purchaser, sued, alleging the offering was part of a fraudulent scheme, aided and abetted by *Central Bank*. The district court granted *Central Bank* summary judgment; the Tenth Circuit reversed, holding that even if an alleged aider and abettor owes no duty to plaintiffs, if that person affirmatively assists a primary violation, liability exists and proof of recklessness is sufficient to sustain it.

The Court's Holding

Yielding to 25 years of precedent, the parties *assumed* aiding and abetting liability existed, but disputed its *scope*.[4] *Sua sponte,* the Court asked them to address *whether* such liability exists, an issue on which the Court had reserved judgment for 18 years.[5] Distinguishing between cases that seek to examine the *scope of conduct* prohibited by § 10(b), and those seeking to determine "the *elements* of the 10b–5 private liability scheme," the Court held the former are governed strictly by "the text of the statute"; the latter can be elucidated by subjective policy arguments, but the Court warned that "10b–5 challenges to conduct not [expressly] prohibited by the text of the statute" may not be pursued.[6]

The Court offered a medley of its greatest restrictive themes of the 1970's and 1980's. It reiterated its prior rejection of SEC efforts to apply a "gloss" to the Federal securities laws by emphasizing the broad congressional purposes underlying those laws. Noting that "the language of Section 10(b) does not in terms mention aiding and abetting," the Court rejected the suggestion that Section 10(b)'s prohibition of conduct "directly or indirectly" operating as a fraud or deceit was the substantial equivalent of the missing words.[7] Absent proof that a defendant engaged in a specifically delineated prohibited activity, liability under Section 10(b) cannot be sustained. Since "Congress knew how to impose aiding and abetting liability when it chose to do so," the Court declined to "amend the statute to create liability for acts that are not themselves manipulative or deceptive . . . ."[8]

Beyond the statutory language, the Court found that Congress did not intend that an aiding and abetting cause of action be implied under Rule 10b–5, since that language is absent from every express securities law private remedy. In addition, the Court emphasized that aiding and abetting liability effectively would nullify the requirement that plaintiffs demonstrate their reliance "on the defendant's misstatement or omission to recover under Rule 10b–5."[9] Vicarious liability is often impossible, since the plaintiffs have no interaction with, and often are not even aware of, a peripheral defendant's existence or conduct. The Court rejected various policy arguments, noting that there is no general basis for the *government* to seek civil penalties or injunctive relief against alleged aiders and abettors, in the absence of express authorization to do so. Moreover, the Court reiterated that, "given a choice, [it] would reject any theory . . . rais[ing the] prospect[]" of hazy issues, protracted litigation, or unreliable predictive ability about the proper resolution of the case.[10]

The Decision's Significance for the SEC

1. *Central Bank* precludes the SEC from imposing Rule 10b–5 aiding and abetting liability. This conclusion, endorsed by the dissent,[11] flows from the decision's interpretation of statutory language, not legislative policy.[12]

2. In future SEC cases, a statute-by-statute approach to civil aiding and abetting liability will apply. The Court expressly noted, for example, that the "SEC may pro-

[4] *See, e.g., Brennan* v. *Midwestern United Life Ins. Co.,* 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd,* 417 F.2d 147 (7th Cir. 1969), *cert. denied,* 397 U.S. 989 (1970). This was the approach followed by the Court itself in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 733 (1975) (court declined to overturn the implication of an implied remedy under Rule 10b–5 after 25 years of lower court acceptance).

[5] *See Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 192 n. 7 (1976).

[6] 62 U.S.L.W. at 4232.

[7] *Id.*

[8] *Id.* at 4233–34.

[9] *Id.* at 4234.

[10] *Id.* at 4237, *citing Virginia Bankshares, Inc.* v. *Sandberg,* 111 S. Ct. 2749 (1991).

[11] 62 U.S.L.W. at 4240 (Stevens, J., *dissenting*).

[12] *See Aaron* v. *SEC,* 446 U.S. 680 (1980).

ceed against brokers and dealers who aid and abet a violation of the securities laws . . . ."[13]

3. Of course, the SEC's ability to pursue broker-dealers alleged to have aided or abetted a Rule 10b–5 violation will require a showing first, that a primary violation of law occurred, and second, that the broker-dealer's conduct was "willful." The "willful" standard requires proof of deliberate misconduct, not mere sleepwalking.[14]

4. The SEC may be able to rely on its 1990 powers to impose cease-and-desist orders, along with certain forms of prophylactic relief, to recapture some causes of action it has lost by virtue of the demise of aiding and abetting liability. The 1990 amendments permit the SEC to proceed administratively against persons who "cause" another person's violation of the Federal securities laws. While this cease-and-desist power is not coextensive with the scope of true aiding and abetting liability, it would enable the Commission to pursue persons who, albeit not primary wrongdoers, took deliberate and *affirmative* steps to cause another person's violation of the law.

5. The Court resurrected the same standards for Rule 10b–5 liability that prevailed in the 1970's and 1980's; that should warrant some restraint in attempts to expand the reach of the Federal securities laws to novel and atypical forms of conduct that do not encompass traditional notions of fraud.

6. The decision places a premium on SEC-initiated enforcement, at the potential expense of private litigation. There will be pressure on the Commission to bring more actions, in light of the fact that certain conduct may not be redressable by private parties, but may be reachable by the Commission in an administrative forum. This could prove to be a double-edged sword for defendants in Commission proceedings, but it eliminates the ransom effect of private litigation that has caused so much undeserved grief to independent professional firms, and particularly the accounting profession and securities brokers and dealers.

7. The SEC may be called upon to employ novel forms of reparation procedures, to replace some of the lost private litigation. The Commission's *Prudential Securities* settlement demonstrates the agency's creativity, in dealing with alleged violations of law, to establish an alternative dispute resolution forum.[15] Given the absence of aiding and abetting liability, the Commission may find it more compelling to turn to these types of novel settlements in the future.

8. Given time, and an increasing awareness of the vicissitudes of litigation, the SEC should not continue to labor under a statute that is ill-defined, at least with respect to insider trading violations. The need for a definition of insider trading (and the procedures applicable to its pursuit) is manifest, and even the SEC has recognized that at various points in the past. In the absence of some legislative help, the SEC continues to face the possibility that private litigants, seeking to stretch the laws beyond their legitimate contours, may cause significant damage to the Commission's own flexible approach to the interpretation of the Federal securities laws.

9. The SEC may seek to require persons who settle cases with it in the future to agree not to open up a consent decree if the operative law governing the settlement is ultimately reversed or modified as a result of a Supreme Court ruling.

10. SEC Chairman Levitt has articulated responsible concerns about private litigation, and has promised that the agency will reevaluate its standard posture with respect to private cases, to ensure that litigation abuses are not permitted to flourish.[16] The Commission's *amicus curiae* position in the *Central Bank* case predated Chairman Levitt's pronouncements. The Commission should rethink its approach to private litigation in light of the views of the Supreme Court.

The Decision's Significance for Securities Professionals and Others Who Have Felt the Sting of Aiding and Abetting Allegations

1. The Court's decision should emancipate peripheral defendants from liability in actions under provisions of the Federal securities laws other than Rule 10b–5. While the decision deals only with Rule 10b–5, its logic would extend not only to implied rights of action under the proxy rules (and, in particular, SEC Rule 14a–9), but also to each of the express remedy provisions of the Securities Act and the Securities Exchange Act, since the Court found that those provisions expressly do not reach aiding and abetting liability.

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[13] 62 U.S.L.W. at 4235.

[14] *See Ratzlaf* v. *United States,* 114 S. Ct. 655 (1994); *Hazen Paper Co.* v. *Biggins,* 113 S. Ct. 1701 (1993).

[15] *In re Prudential Securities, Inc.*, Sec. Exch. Act Rel. No. 33082 (Oct. 21, 1993).

[16] *See* Arthur J. Levitt, Jr., Chairman, Securities and Exchange Commission, REMARKS AT SAN DIEGO SECURITIES REGULATION INSTITUTE (Jan. 26, 1994).

2. Defendants that settled charges of aiding and abetting Rule 10b–5 violations by consenting to injunctive relief at the SEC's behest, should have a basis for moving to lift the injunctions or other remedies imposed, based upon a mistake of law.

3. For companies and individuals confronted by possible SEC enforcement charges, settlement negotiations should focus on charges of aiding and abetting violations, and should be brought pursuant to statutory provisions that explicitly authorize the Commission to pursue such misconduct. In that manner, the settlement of the SEC's charges should minimize the possibility that private parties can utilize the settlement as a predicate for "piggy-back" liability.

4. *Central Bank* may not provide as much respite for professionals and other deep-pocketed peripheral defendants as hoped, since private parties can be expected to cloak charges of aiding and abetting in the guise of primary violations of law. Courts should prove receptive, however, to motions to dismiss on the ground that the substance of an allegation is nothing more than the "wolf" of a charge of aiding and abetting in sheep's clothing.

5. Of course, even if a private action could withstand a motion to dismiss, *Central Bank* should provide defendants with considerable new settlement negotiating leverage. Apart from the rather obvious risk that a defendant's conduct will not ultimately be found to constitute a primary violation of law, the Court's decided hostility toward theories of liability that can be characterized as "ad hoc," or offering little "certainty and predictability," or requiring "shifting and highly fact-oriented disposition[s],"[17] provide ample fodder for dispositive motion practice regarding the underlying substantive allegations of liability.

6. The *Central Bank* decision presages the potential demise of *respondeat superior* and other forms of non-statutory vicarious liability for brokerage firms and others under the Federal securities laws. In the absence of express authorization for such liability, the Court's decision makes it unlikely that it would countenance the implication of such liability in the context of implied actions under Rule 10b–5. The fact that § 20(a) of the Securities Exchange Act specifically contemplates controlling person liability, and establishes clear standards for its invocation, suggests that all other forms of vicarious liability will not be tolerated under Rule 10b–5.

7. In rejecting the SEC's argument that the Federal criminal aiding and abetting liability statute[18] was an appropriate predicate for implying civil aiding and abetting liability under the Federal securities laws, the Court hinted at the possibility that "recklessness, . . . [as opposed to] intentional wrongdoing" would not be an acceptable basis for imposing liability.[19] The Court never reached the issue squarely in *Central Bank*, but the tenor of the decision, and some of its language, suggests that even where aiding and abetting liability can be pursued by the SEC, the appropriate standard of liability will be intentional wrongdoing.

8. Although the Court acknowledged that secondary actors in the securities markets will not "always [be] free from liability under the securities Acts," it articulated a rather difficult threshold burden for the SEC or private parties to meet:

> [a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b–5, assuming *all* of the requirements for primary liability under Rule 10b–5 are met.[20]

Conclusion

Rule 10b–5 has been an important staple of the SEC's arsenal of weapons against fraudulent misconduct. Over the years, however, Rule 10b–5 has been overused and abused by private litigants, who seek to enmesh professionals with high capitalization, or impressive insurance policies, in shareholder litigation. In eliminating one of the principal abuses of private securities litigation, the *Central Bank* decision has given securities professionals some breathing room in the constant struggle of asserted liability. Just how much breathing room has been afforded remains to be seen.

[17] 62 U.S.L.W. at 4237.
[18] U.S.C. § 2 (1988).
[19] 62 U.S.L.W. at 4237.
[20] 62 U.S.L.W. at 4237–38.

ATTACHMENT D

SUMMARY OF TESTIMONY OF HARVEY L. PITT REGARDING THE BRYAN AMENDMENT TO S. 543

OCTOBER 2, 1991

Mr. Chairman, Members of the Subcommittee: I am pleased to appear before you today to discuss the Bryan Amendment to S. 543, the omnibus Senate Banking Bill. I appear before you today on behalf of the American Institute of Certified Public Accountants and the "Big Six" accounting firms, Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse. By way of introduction, I am Managing Partner of the Washington, DC office of the law firm of Fried, Frank, Harris, Shriver & Jacobson, and I chair the Corporate Department of the Washington Office. From 1968 to 1978, I was an attorney on the staff of the Securities and Exchange Commission, the last 3 years of which I was privileged to serve as General Counsel of the SEC. I have developed during my almost 25 years of practice as a securities lawyer a fair number of personal views on this important topic, which I would like to share with the Subcommittee.

Statutes of limitations, often negatively perceived as barriers to redress by injured parties, actually perform a critical and salutory function in our legal system. They encourage the prompt filing of claims and limit litigation of stale claims. In times like these, when the bandwagon of stern enforcement is in the vanguard of our society, it is difficult to draw any lines at all, since any line drawn would limit someone's remedies.

My testimony, a copy of which is attached, begins with a few observations about the Federal securities laws, first tracing the recently shifting relationship between SEC enforcement actions and private litigation, and then describing the process by which the Rule 10b–5 cause of action and the current statute of limitations period evolved. Among other things, I point out that Congress has, within the last decade, positioned the Securities and Exchange Commission in the forefront of securities enforcement, empowering the SEC with instructions and authority to seek disgorgement from courts and to order it administratively for every violation of the Federal securities laws. The SEC has not yet implemented its new powers, and until it does, any legislative adjustment to the recovery rights of plaintiffs would, in my view, be premature. I also point out the anomoly of gracing remedies *implied* by the courts from the Federal securities laws a longer limitations period than those Congress provided to the *express* remedies.

Next, my testimony highlights various problems in the legal and practical framework of securities litigation. The system, as it has developed, now fosters policies we all would agree are inappropriate. Defendants are sued and then forced into settlement for reasons wholly unrelated to the merits of the case. Injured parties receive little compensation for their injuries, although huge sums are expended to resolve the conflicts. I suggest that Congress should not revise the statute of limitations without examining the problems inherent in private securities litigation.

Finally, my testimony addresses problems peculiar to the Bryan Amendment. I outline various considerations that support a shorter limitations period, including the need of businesses and individuals to be notified promptly of claims against them and to close the chapter on difficult periods knowing that all claims that could have been filed have been resolved. I also point out that eliminating the "reasonable diligence" requirement originally in the Amendment would inappropriately encourage plaintiffs who already are aware of facts indicative of fraud to avoid inquiring further, and instead to remain in a state of intentional ignorance for years before taking the steps necessary to determine whether to pursue a claim. I also point out that it would be unfortunate to encourage a system of lawmaking where persons affected negatively by Supreme Court decisions sought to undermine the notion of finality of Court decisions by urging Congress to enact contrary legislation.

The problems attendant to securities litigation and the concerns prompted by the language of the Bryan Amendment suggest that extending the limitations period for an already troubled cause of action would be counterproductive. Important issues, such as the possibility of requiring losing parties to pay the legal expenses of parties who prevail in litigation and ensuring that nonsettling defendants will be liable to pay only the percentage of damages resulting from their conduct, certainly should be explored. Any adjustment to the remedy afforded investors under Rule 10b–5 should be considered only in the context of a broader analysis of implied private remedies under the Exchange Act.

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PREPARED TESTIMONY OF HARVEY L. PITT REGARDING THE BRYAN AMENDMENT TO S. 543

OCTOBER 2, 1991

Introduction

Mr. Chairman, Members of the Subcommittee: I am pleased to appear before you today to discuss the Bryan Amendment to S. 543, the omnibus Senate Banking Bill.[1] The Bryan Amendment does not address the difficult banking issues tackled by S. 543. Instead, it would statutorily overrule a decision by the United States Supreme Court issued less than 4 months ago[2] defining the appropriate statute of limitations for private actions implied under the Securities Exchange Act of 1934 (the "Exchange Act").[3] I appear before you today on behalf of the American Institute of Certified Public Accountants and the "Big Six" accounting firms, Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick, and Price Waterhouse.

By way of introduction, I am Managing Partner of the Washington, DC office of the law firm of Fried, Frank, Harris, Shriver & Jacobson, and I chair the Corporate Department of my firm's Washington Office. From 1968 to 1978, I was an attorney on the staff of the Securities and Exchange Commission, the last 3 years of which I was privileged to serve as General Counsel of the SEC. During my almost 25 years of practice as a securities lawyer, I have developed a number of personal views on this important topic which I would like to share with the Subcommittee.

Overview

The Bryan Amendment would change the statute of limitations for *implied* (but not the express) private rights of action under the Exchange Act from the formulation recently approved by the Supreme Court[4] of 1 year after discovery of the violation, with an outside limit of 3 years after the violation, to a significantly longer period of 2 years after discovery, with an outside limit of 5 years. In addition, although the Bryan Amendment initially included a provision commencing the 2 year limitations period after the plaintiff discovered, *or should have discovered,* the violation, those words were changed during mark-up so that now the Amendment is likely to be read to preclude the 2 year period from commencing until after *actual* discovery of the violation. Moreover, the Bryan Amendment would apply the new limitations period retroactively, reviving causes of action currently precluded by law.[5]

Statutes of limitations, often negatively perceived as barriers to redress by injured parties, actually perform a critical and salutary function in our legal system. They encourage the prompt filing of claims and limit litigation of stale claims. Negative connotations sometimes are inferred by partisans because the bright lines Congress draws for causes of action in every field of law are, in each instance, arbitrary lines that force injured parties *promptly* to allege their claims.[6] Individual cases in which time has robbed plaintiffs of an opportunity for redress in their forum of choice can be heartbreaking. Indeed, in times like these, when the bandwagon of stern enforcement is in the vanguard of our society, it is difficult to draw any lines at all, since any line drawn would limit someone's remedies.

A balanced approach and an objective review are essential if justice is to be achieved. Your task requires examining carefully all sides of the issues and then deciding whether to disturb the line drawn by the Supreme Court. I hope my testimony assists you in that process. My testimony begins with a few observations about the Federal securities laws, first tracing the recently shifting relationship between SEC enforcement actions and private litigation, and then describing the process by which the Rule 10b–5 cause of action and the current statute of limitations period evolved. Next, I shall highlight various problems in the legal and practical

[1] Senator Bryan introduced an amendment to the Senate Banking Bill, S. 543, and it was adopted on August 5, 1991, by a voice vote in the last few minutes of a 3-day mark-up session, with no prior hearings or debate.

[2] *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson, 111 S. Ct. 2773 (1991).*

[3] 15 U.S.C. § 78a *et seq.* (1988).

[4] *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson, 111 S. Ct. at 2773.*

[5] *See generals James B. Beam Distilling Co.* v. *Georgia,* 111 S. Ct. 2439, 2441 (1991) (holding that a 1984 Supreme Court ruling applied retroactively to claims arising on facts occurring prior to the decision, a ruling that supports retroactive application of the *Lampf* decision).

[6] In the context of determining the proper limitations period for private civil actions brought under Exchange Act Section 18, Senator Byrnes said, "Of course where a period is fixed arbitrarily, men will disagree about it." 78 Cong. Rec. 8200 (1934) (statement of Senator Byrnes).

framework of securities litigation, suggesting that Congress should examine the bigger picture before adjusting a facet of the process. I then shall outline various considerations that support a shorter limitations period, including the need of businesses and individuals to be notified promptly of claims against them and to close the chapter on difficult periods knowing that all claims that could have been filed have been resolved. In conclusion, I shall examine the concepts of reasonable diligence and retroactivity, presenting legal and practical concerns prompted by the current formulation of the Bryan Amendment.

Private Actions Under the Federal Securities Laws

THE HISTORICAL RELATIONSHIP BETWEEN PUBLIC AND PRIVATE PROSECUTORS OF SECURITIES FRAUD CLAIMS

For most of the first 50 years of securities regulation in the United States, the SEC eschewed a significant role as a collection agency for injured parties, generally leaving to those claiming injury the task of pursuing their own claims and obtaining their own relief. Private actions under the Federal securities laws were deemed a "necessary supplement" to the prosecutorial efforts of the government.[7] In 1984, when adopting the Insider Trading Sanctions Act of 1984, Congress affirmatively encouraged the SEC to seek "disgorgement of ill-gotten gains which may, if appropriate, be paid into an escrow fund so that traders or other private parties damaged by the insider trading can obtain compensation for their losses."[8] At least, from that point forward, the Commission aggressively argued that persons prosecuted for fraud under Exchange Act Section 10(b) and Rule 10b–5 thereunder should not be allowed to retain the benefits of their ill-gotten gains, but rather should be required to disgorge them to a Federal court, to be distributed later to investors who claim to have been injured by the defendant's insider trading violations. Victims of an insider trading violation have the capacity to recover for their losses by petitioning the court, without filing their own lawsuit against other parties, and without incurring the burden of the costs of prosecuting their own claims. At the SEC's urging, courts have begun requiring disgorgement of funds in cases other than insider trading, expanding the number of violations for which disgorgement pools were available.[9]

One year ago this month, the Securities Enforcement Remedies and Penny Stock Reform Act became law, enabling the SEC to bypass the Federal courts entirely, and to proceed through its own administrative system to require defendants to disgorge ill-gotten gains obtained as a result of *any* violation of *any* provision of the Federal securities laws.[10] The Commission has not yet begun to implement its new power. And, although its Administrative Process Task Force has been evaluating the SEC's administrative processes and has received input from a variety of sources, the results of the evaluation have not yet been made public.[11] Until the Task Force has reported and the SEC's new powers have been implemented their impact cannot be evaluated. Any legislative adjustments to the recovery rights of plaintiffs would be premature without that analysis.

Because the SEC takes the position that no statute of limitations applies to its enforcement prosecutions,[12] its cases often are prosecuted long after the expiration of any limitations period for private actions.[13] As a result, by endorsing court-ordered disgorgement and authorizing SEC-ordered administrative disgorgement, Congress already has established a procedure by which private plaintiffs who do not prosecute their own claims in a timely fashion, or who remain unaware of securities

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[7] *See, e.g., J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

[8] H.R. REP. NO. 355, 98th Cong., 1st Sess., at 25.

[9] *See, e.g., Securities and Exchange Comm'n* v. *First City Fin. Corp.*, 890 F.2d 1215 (D.C. Cir. 1989) (upholding an order of disgorgement of profits from a violation of Exchange Act Section 13(d)).

[10] 15 U.S.C. §§ 78u–2, 3 (1991).

[11] SEC Commissioner Mary L. Schapiro chairs this Task Force, which was formed during the summer of 1990. *See SEC Starts Review of Law Proceedings to Speed Up Cases*, WALL ST. J., July 20, 1990, at C18, col. 3. Input was provided by, among others, an ad-hoc committee of the American Bar Association's Committee on Federal Regulation, of which I am a member, and by the Task Force on SEC Settlements, authorized by that ABA Committee and which I chair.

[12] *See Unpublished Memorandum Opinion*, SEC, Aug. 11, 1952.

[13] I question the correctness of the SEC's views on the inapplicability of any statute of limitations to it. *See, e.g., SEC* v. *Glick*, [1980 Transfer Binder] CCH Fed. Sec. L. Rep. ¶97,535 (D. Nev. 1980) (While allowing the action, the court noted "the fact that the SEC . . . is not bound by any specifically delineated statute of limitations does not mean that it possesses unlimited or perpetual power to obtain injunctive relief for past conduct.")

law violations until after the limitations period has passed, may, nevertheless, recover for their injuries from disgorged funds.

Congress should also consider carefully what the implications are of any relaxation in longstanding limitation periods—namely, the encouragement of additional Federal litigation. Such a result runs counter to the efforts Congress has been pursuing over the years to curtail the litigation explosion, while preserving legitimate claims for relief. Thus, in addition to the Insider Trading statutes, Congress has also adopted the Administrative Dispute Resolution Act, which became law in November of last year, requiring Federal agencies including the SEC to "adopt a policy that addresses the use of alternative means of dispute resolution and case management."[14] Although the SEC currently refuses to entertain requests for arbitration of its claims, presumably once it adopts procedures, those procedures may include the concept of a disgorgement fund to reimburse plaintiffs for their injuries. Moreover, State court remedies often are available to address plaintiffs' concerns. All of these alternatives argue forcefully against expanding the length of time in which to allow plaintiffs to prosecute their own securities law claims.

EVOLUTION OF PRIVATE ACTIONS UNDER RULE 10b–5

The Bryan Amendment would assign a limitations period for causes of action not drafted by Congress, but rather created by the courts. As the Subcommittee is aware, plaintiffs may sue for violations of the Federal securities laws by asserting causes of action from two categories: (i) those expressly set forth by statute,[15] and (ii) those not stated expressly but nevertheless implied by the courts,[16] including the ubiquitous Rule 10b–5.

As creations of the courts rather than Congress, private rights of action under Rule 10b–5 have evolved through the years in a piecemeal fashion. Various issues were resolved in different ways by the courts, prompting conflicts among the circuits and in some cases resulting in Supreme Court opinions settling the issues.[17] In that fashion, the Federal court system honed a statute of limitations for the Rule 10b–3 private remedy the Federal judiciary had created:

> **First,** the Federal courts each decided what, in their view, was the "best" approach, generally "borrowing" the State statute of limitations applicable to the most analogous State cause of action. This approach prompted almost as many differing statutes of limitations as there were district courts, since each court determined that a different cause of action provided the best analogy. The American Bar Association's Committee on Federal Regulation of Securities examined the problem, noting that in 1986, "the limitations periods for rule 10b–5 actions range from 1 year on Maryland to 10 years in Tennessee. It is uncertain what statute of limitation is applicable in several Federal circuits, and there is no controlling precedent in thirteen States."[18] One Federal court of appeals judge characterized the absence of a uniform limitations period as "one tottering parapet of a ramshackle edifice."[19]
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> **Second,** in 1983, the Supreme Court laid the groundwork for a more consistent approach, rejecting the previously favored "borrowing" method of determining the appropriate statute of limitations for implied rights of action.[20] Instead, in the context of a case brought by employees against their unions for breach of the duty of fair representation, the Court established a uniform Federal limitations period.[21]
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> **Third,** in 1987, the Court underscored its determination to eliminate the "borrowing" confusion, establishing a uniform statute of limitations for RICO actions.[22]

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[14] Pub. L. 101–552, 104 Stat. 2736 (1990).

[15] In the Exchange Act, these express remedies can be found at Sections 9, 16, 18, 20A and 29. Sections 9, 18 and 29 carry statutes of limitations of 1 year/3 years; the limitations periods for Sections 16 and 20A are 2 and 5 years, respectively.

[16] *See, e.g.*, actions implied under Exchange Act Section 10(b) and Rule 10b–5; Section 13 and Rules 13e–3 (b) and (c) and 13e–4(b); Section 15(c) and Rules 15c1–1 through 15c1–9.

[17] *See, e.g., Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975) (holding that only purchasers or sellers of securities may sue for damages arising from a violation of Rule 10b–5).

[18] ABA Committee on Federal Regulation of Securities, *Report of the Task Force on Statute of Limitations for Implied Actions*, 41 Bus. Law. 645, 646 (1986) (citations omitted).

[19] *Norris* v. *Wirtz*, 818 F.2d 1329, 1332 (7th Cir.), *cert. denied*, 484 U.S. 943 (1987).

[20] *See DelCostello* v. *Teamsters*, 462 U.S. 151 (1983).

[21] *Id.*

[22] *Agency Holding Corp.* v. *Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 148 (1987).

Fourth, Circuit courts began to reject the "borrowing" notion as well. The Second,[23] Third,[24] and Seventh[25] circuits all examined the issue of the appropriate statute of limitations in Rule 10b–5 cases and determined that such cases should be filed in Federal court within 1 year after the plaintiff discovered, or should have discovered, that the securities law violation occurred, and in every event, within 3 years after the violation.

Fifth, in June of this year, the Supreme Court examined Exchange Act Section 10(b) and Rule 10b–5 in the context of the Exchange Act as a whole, compared the limitations periods assigned to the express causes of action in the Exchange Act, analyzed the peculiar needs of implied causes of action under the Rule, and adopted the 1 year/3 year limitations period we are discussing today.[26]

The Bryan Amendment would interrupt this process with a bizarre twist on traditional principles of lawmaking, establishing an express statute of limitations for causes of action Congress did not create. Moreover, in doing so, Congress would grace the *implied* remedies, which are much more expansive in scope and application than the express statutory remedies, with a limitations period superior to those afforded to the *express* statutory remedies. Rather than rushing to legitimize and elevate the bastardized claims created by the judiciary, Congress should examine carefully the implied remedies with a view toward a more effective and efficient context for private securities litigation.

The Need for a Comprehensive Examination of Private Securities Litigation

As with many causes of action implied from Federal statutes, private rights of action under Rule 10b–5 have evolved into a thicket, difficult and painful to explore. To prune one branch of the thicket without considering whether the entire thicket needs attention could cause undesirable growth in another area, a problem that could be avoided with a more thoughtful and thorough approach.

Indeed, it was just such a thoughtful and thorough approach that resulted in the most recent express cause of action in the Exchange Act, Section 20A.[27] Congress became aware that courts had precluded persons who sold or purchased into the market contemporaneously with trades by persons in possession of misappropriated nonpublic, material information from recovering civil damages.[28] Instead of merely correcting what it viewed as an inappropriate limit on civil plaintiffs by quickly creating a statutory remedy, Congress carefully considered the impact such a remedy might have on all parties and on the litigation system itself. As a result, limits were placed on the remedy to ensure not only a clearly defined avenue for injured parties to follow toward recovery, but also reasonable parameters on that recovery. For example, Section 20A recognizes that the general controlling person liability provision in the Exchange Act applies to this new private remedy, but precludes *respondeat superior* liability.[29] It also limits recovery to the profits gained or loss avoided, and offsets disgorgement made by the defendant to the Government from the amount of the plaintiff's recovery.[30] On the other hand, Section 20A allows an expansive 5 year statute of limitations for its narrow cause of action.[31] The entire scope of implied private rights of action under the Federal Securities laws are in need of similar, comprehensive examination.

SYSTEMIC PROBLEMS IN CLASS ACTION LITIGATION

With all due respect to my colleagues who represent plaintiffs in class action lawsuits, the system in which they function is, in my view, sorely in need of revision. If a company's stock suddenly rises or falls by an unusual amount, complaints are

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[23] *Ceres Partners* v. *GEL Assocs.*, 918 F.2d 349 (2d Cir. 1990).

[24] *In re Data Access Systems Securities Litigation*, 843 F.2d 1537 (3d Cir.), *cert. denied*, 488 U.S. 849 (1988).

[25] *Short* v. *Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991).

[26] *Lampf* v. *Gilbertson*, 111 S. Ct. at 2773.

[27] 15 U.S.C. § 78t–1 (1988).

[28] *See, e.g., Moss* v. *Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

[29] *See* Exchange Act Section 20A(b)(3), 15 U.S.C. § 78t–1(b)(3) (1988); Report of the Committee on Energy and Commerce, United States House of Representatives on H.R. 5133, H.R. Rep. No. 100–910, 100th Cong. 2d Sess. (1988).

[30] Exchange Act Section 20A(b)(1)–(2), 15 U.S.C. § 78t–1(b)(1)–(2) (1988).

[31] Exchange Act Section 20A(b)(4), 15 U.S.C. § 78t–1(b)(4) (1988). Section 20A claims, unlike most Section 10(b) claims, involve damages that are "fixed within days after the training, sometimes within hours. No one has a free put or call of securities; no one can use delay in bringing suit to speculate on the firm's future prosperity." *Short* v. *Belleville Shoe Mfg. Co.*, 908 F.2d 1385, 1392 (7th Cir. 1990), *cert. denied*, 111 S. Ct. 2887 (1991).

drafted overnight using boilerplate language. Everyone who ever worked with or for the issuer can be a target, and the laundry list inevitably includes accountants, whether or not there is any basis to believe the accountants did anything improper.[32] The importance of speed, of course, is unrelated to obtaining appropriate redress for the injured parties: Indeed, a few weeks of thoughtful investigation prior to filing the action could allow a more careful pleading that would survive the early stages of motions to dismiss. Rather, speed enhances the likelihood of the attorneys involved winning the prize of being named plaintiffs' counsel, a lucrative pay-off for the victor.

Recent studies demonstrate the structural deficiencies in the class action system that many of us with anecdotal experience have observed.[33] For example, Professor Janet Cooper Alexander of Stanford Law School examined the computer industry companies in Northern California who undertook an initial public offering of at least $3 million during the first half of 1983, focusing on what happened to those companies when the market for computer-related stocks collapsed later that year. Some companies became the subject of class action lawsuits, and some did not—she endeavored to determine the reason for this result. Among other exercises, Professor Alexander multiplied the number of outstanding shares at each company by the amount of the price drop in share price during the market collapse, thereby obtaining the amount by which each company's securities decreased in value as a result of the drop. *Every* company losing $20 million or more in shareholder equity was sued, while *no* company losing less than $20 million in shareholder equity was sued. This was true even though several companies whose overall dollar losses were less than $20 million suffered greater losses as a percentage of their overall company value. Professor Alexander concluded from this data that class action suits were brought based on a mathematical formula of total money available from the lawsuit, regardless of the merits of the claims alleged.[34]

Once plaintiffs' counsel has been named, the battle (well known by defense lawyers) begins. Indignant defendants react immediately, and usually angrily, telling their lawyers they want to fight the meritless allegations to the end, a refrain that brings music to any lawyer's ears. Motions fly, and the Complaint is dissected for defects that might be fatal. The first round of court challenges waits pending before the judge, and the first legal bills come in. The defendant's insurance company also enters the scene, holding the purse strings that will enable the litigation to continue or force it to end. However, the insurer is in a difficult position, because the costs of litigation are so high that settlement for a nominal amount as quickly as possible is preferable. But, if the insurer attempts to override the recommendations of counsel, allegations of bad faith may ensue—and once that happens, the limits on the insurance policies may be lifted. Moreover, while settlements by directors and officers may be covered by the policy, damages assessed at the conclusion of trial generally are not. These concerns often prompt difficult negotiations that further add to the costs of the litigation.

Also fueling the costs of litigation are the burdens of discovery, which inevitably fall upon the defendants, since there often is little to discover from the plaintiffs that might be relevant to the litigation. "The prospect of extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents, is a common occurrence in this and similar types of litigation."[35] Hastily drafted discovery requests prompt court attention to tailor the requests more appropriately to the litigation at hand, and then require hundreds (or, in some cases, thousands) of hours both by lawyers and by company employees (diverted from other tasks in economic times necessitating fewer employees). Inevitably, defendants once determined to clear their names from hastily crafted and inappropriate allegations lose their enthusiasm as the time commitment and legal fees required by litigation come more clearly into focus. As the Supreme Court has noted:

> To the extent [liberal discovery rules] permit[] a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather

[32] Fischel, *The Regulation of Accounting: Some Economic Issues*, 52 Brooklyn L. Rev. 1051, 1054 (1987).

[33] See, e.g., Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991) (*"Do the Merits Matter?"*); O'Brien, *The Class-Action Shakedown Racket*, Wall St. J., Sept. 10, 1991, at A20, col. 3 (reporting on a recent study by California economist, Vincent E. O'Brien).

[34] Alexander, *Do the Merits Matter?* at 514–15.

[35] *Blue Chips Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 741 (1975).

than a reasonably founded hope that the process will reveal relevant evidence, it is a social cost rather than a benefit.[36]

Most class action lawsuits are settled, 96 percent of those filed within the past 3 years.[37] Unfortunately, it appears that these settlements are not bargains struck depending on the merits of the case, but rather are fairly consistent in percentage of the total damages alleged. Professor Alexander found that the majority of the lawsuits brought against the companies she studied had settled for approximately 25 percent of the total potential damages.[38] Class action plaintiffs (most of whom are institutional investors) receive only approximately 60 percent of the settlement amount, with the remainder going to attorneys' fees and litigation expenses.[39] Professor Alexander noted, "a strong case in this group appears to have been worth no more than a weak one,"[40] concluding that "[t]he malfunctioning litigation process itself causes claims to be brought and then coerces a payment"[41] in a process that is "almost unbelievably expensive and inefficient."[42]

This process is especially unfair to accountants who do not stand to gain from securities transactions by their clients, but rather are paid only a fee. Notwithstanding this distinction, accountants face the possibility of huge damage awards. While the threat of large verdicts should not daunt an innocent defendant, no trial's outcome is a certainty. Moreover, if defendants who do not settle before trial ultimately are found liable to the plaintiff, it is possible that they will be forced to pay not only their proportionate share of the liability assigned, but the unpaid shares of settling defendants as well.[43] This puts tremendous pressure on defendants to settle, and leaves observers comparing securities litigation with the unfortunate parallel of extortion.

CRIPPLING INSURANCE COSTS ALREADY IMPEDE AMERICAN ENTREPRENEURIAL EFFORTS

Before further and needlessly expanding the liability exposure of American businesses, Congress should think carefully about the results such a move is likely to prompt.[44] Already, the costs of director and officer liability insurance and the risks individuals must bear to work in corporate America are taking their toll on the ability of corporations to attract and retain executives with the experience necessary to guide the companies.

Companies are responding to these pressures in a variety of ways, many of which tragically demonstrate the need for liability reform. For example, Armada Corporation, a Detroit-based manufacturer of alloys and exhaust systems, was faced 7 years ago with a premium increase from $47,000 to $720,000 for $10 million in coverage.[45] Simultaneously, the deductible also was increased—from $125,000 to $750,000. In response, Armada eliminated its D&O insurance altogether, a move which prompted eight of the company's ten directors to resign. The company's president, in explaining why Armada had concluded that the profile of its Board of Directors must change, stated:

> We decided we could only afford to have low-net-worth people to replace the directors who left. . . . Without insurance, the directors' only protection is that the company will indemnify them for any liability. And we explained to them that we

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[36] *Id.*

[37] O'Brien, *The Class-Action Shakedown Racket,* Wall St. J., Sept. 10, 1991, at A20, col. 3. *See also* T.M. Jones, *An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits,* 60 B.U.L. Rev. 542, 544–545 (1980) (246 of 275 shareholder and derivative actions brought between 1971 and 1978 and that had proceeded past the pleading stage were settled); J.E. Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study,* 14 Hous. L. Rev. 769, 810–811 (1977) (finding that 29 of 31 cases filed in the Northern District of Texas that had proceeded past the pleading stage were settled).

[38] Alexander, *Do the Merits Matter?* at 517.

[39] *Id. See also* O'Brien, *The Class-Action Shakedown Racket,* Wall St. J., Sept. 10, 1991, at A20, col. 3.

[40] Alexander, *Do the Merits Matter?* at 500.

[41] *Id.* at 569.

[42] *Id.* at 571.

[43] *See Singer* v. *Olympia Brewing Co.,* 878 F.2d 596 (2d Cir. 1989), *cert. denied,* 110 S. Ct. 729 (1990). *See generally Franklin* v. *Kaypro Corporation,* 884 F.2d 1222 (9th Cir. 1989) (adopting a pro-rata method for calculating liability), *cert. denied sub nom., Franklin* v. *Peat Marwick Main & Co.,* 111 S. Ct. 232 (1990).

[44] *See generally* P.W. Huber, LIABILITY (1988); Pitt & Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct,* 78 Geo. L. J. 1559 (1990).

[45] *See* McGrayne, *K Mart Corp. Squeezes State to Aid Directors,* CRAIN'S DETROIT BUS., Jan. 12, 1987, at 1.

couldn't very well indemnify them for $10 million. So we found well-qualified people who are a little younger, whose net worth is low enough so we don't have a problem.[46]

Companies devote extensive resources searching for ways to preserve their ability to attract valuable outside directors and to limit in every way possible the likelihood that their activities will cause them to be named as defendants. This effort as well diverts much of the creative attention from healing our economy.

The Bryan Amendment

THE 1 YEAR/3 YEAR LIMITATIONS PERIOD ADDRESSES IMPORTANT POLICY CONCERNS

The Need for Prompt Notice of Claims

Just as plaintiffs and would-be plaintiffs may present distressing tales, there are countervailing accounts of innocent defendants who have been notified too late of claims against them, rendering them unable to gather crucial evidence to support their defense because the evidence has been lost or discarded in the normal course of business, and people have forgotten critical details. These problems are exacerbated in the context of claims of Federal securities law violations, and particularly actions under Exchange Act Section 10(b) and Rule 10b–5 thereunder, for a variety of reasons.

First, as has become the vogue in many areas of litigation, complaints alleging violations of the Federal securities laws fire allegations of fraud in a scattergun approach, often in what appears to be an effort to hit every possible party who is covered by an insurance policy. Everyone who ever worked with or for the issuer can be a target, and the laundry list inevitably includes accountants, as well as many other advisors, whether or not there is any basis to believe the advisors did anything improper. As a result, the ripples into the business community resulting from a longer statute of limitations for private claims implied under the Federal securities laws reach far beyond the initial impact on publicly held companies, and all attendant costs (additional recordkeeping costs, legal fees, time diverted from productive activities, etc.) must be multiplied exponentially.

Second, in almost every instance, records are voluminous. The mere fact that a business is in some way related to securities necessitates a very detail oriented, paper ridden workplace. If business people, accountants, broker-dealers, lawyers or other professionals do not know what might be necessary to defend claims of which they are not yet aware, they must retain all records to preserve their ability to reconstruct what really happened in order to defend themselves. The costs of storing documents that most likely will be useless can be exorbitant.

Third, the details of securities transactions are difficult to separate one from the other, as anyone who has deposed a broker can attest: thousands of transactions occur daily, and scores of precipitous price breaks in a variety of securities occur yearly. The more quickly a plaintiff acts after having reason to know action is appropriate, the more likely it is that the inevitable crush of subsequent details has not wiped out all recollection of particular circumstances.

Fourth, to state a claim under Rule 10b–5, a plaintiff must allege a fraudulent misrepresentation or omission.[47] Evidence to support the allegations should be gathered quickly to ensure accuracy, and the discovery process cannot begin until after a complaint is filed.[48] When the mosaic that should be presented by all relevant evidentiary pieces is distorted by what is missing (an inevitable result when several years have passed), the pieces that remain can take on an inflated importance in the minds of those attempting to prosecute the case. Inferences from circumstantial evidence often are insufficient to support allegations of fraud, so the claims when litigated generally are left unsatisfied. But the costs of demonstrat-

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[46] Lewin, *Director Insurance Drying Up*, N.Y. TIMES, March 7, 1986, at D1, col. 3.

[47] *See* Rule 10b–5, 17 C.F.R. § 240.10b–5 (1991).

[48] This is an important distinction between private civil actions and actions brought by governmental agencies who have investigatory powers and responsibilities that require significant investigation prior to bringing a case. Although both parties are held to the standards of Rule 11 of the Federal Rules of Civil Procedure, and thereby must have grounds on which to base a claim, the Government should, and generally does, go far beyond merely having grounds on which to proceed, conducting a complete investigation into the merits of the case prior to making the decision of whether to allocate resources to prosecute it. Congress has empowered them to do so, by providing subpoena power prior to the institution of a lawsuit. We rely on prosecutorial discretion to ensure wise use of such a powerful investigatory tool. In turn, we expect that cases brought by the Government are well-researched, solid cases that are likely to win.

In contrast, private plaintiffs are allowed to subpoena docents and witnesses only *after* filing their complaint. Thus, the more quickly a complaint is filed, the more quickly relevant evidence can be gathered.

ing that securities fraud allegations are meritless are exorbitant, as many of my clients can attest. For each additional year in which a plaintiff may bring a cause of action, the costs to the defendants who ultimately are named rise tremendously.

In sum, drawing the line at a shorter period of time allows (i) defendants to be put on notice that their actions have been called into question, (ii) applicable evidence to be preserved, and (iii) depositions to be taken before recollections fade, thereby reducing the likelihood of stale claims and significant proof problems.

Parallels to Another Era: The Need for Closure

The Subcommittee is examining this issue at a difficult point in our Nation's history. Four years ago this month, our stock market crashed, causing the value of common stocks in the United States to decline by approximately 30 percent within one week.[49] Businesses still suffer from the ramifications of that jolt. Our economy is now in the midst of a full-fledged recession. The pressure of an economy overburdened by increasing governmental debt is crippling our businesses. Statistics announced each week indicate that more and more businesses are laying off employees, cutting costs, limiting (or even eliminating) research and development, and falling behind in their ability to compete with other nations. We are in a crisis in this country, and the businesses that drive the economy should not be overlooked amid zeal to address anecdotal concerns.

Another Congress faced a similar challenge: four years after the stock market crash of 1929, the 72nd Congress drafted and enacted the Securities Act of 1933 (the "Securities Act"), and the following year, the 73rd Congress drafted and enacted the Securities Exchange Act of 1934 (the "Exchange Act"). In doing so, they were ever mindful of the problems—and the victims—of the market crash and the subsequent economic strains facing American businesses. In an age where there were no fax machines and when overnight delivery services between States were the exception, rather than the norm, Congress set the limitations periods for express private causes of action under the Exchange Act generally in accordance with what is now known as the "1 year/3 year rule."[50] Although in 1933, Congress had established a 2 year/10 year limitations period in the Securities Act, it determined in 1934, after careful consideration, that it was in the best interest of the economy as well as those injured by securities law violations to impose a 1 year/3 year limitations period in the Securities Act as well.[51]

The legislative history of the Exchange Act indicates that Congress, in setting these limits, imposed the 3 year outside limit to avoid stale claims and to allow businesses to proceed with a sense of finality about the past.[52] To further encourage swift action upon discovery of a securities law violation, Congress imposed a 1-year limit to encourage prompt filings of claims and to discourage speculators from delaying filing their actions while observing the subsequent price of the securities.[53] Courts examining the issue of statutes of limitations under the Exchange Act have noted that concern as well. For example, the Court of Appeals for the Seventh Circuit, in the context of assigning for claims under Exchange Act Section 10(b) the 1 year/3 year limitations period for Exchange Act Section 13, stated:

> If suit may be postponed indefinitely on equitable grounds, then investors may gamble with other people's money. . . . Prudent investors almost always can sniff out fraud (or enough smoke to justify litigation) within 3 years. Section 13 cuts off only the claims of the most trusting or somnolent—or the most wily, those who wanted to wait as long as possible.[54]

Particularly now, as businesses attempt to pull themselves out of the mire and move onward during a difficult economic period and in a hostile business environment, it is important that businesses know with some certainty when liabilities allegedly incurred in the past can be put behind them. The Supreme Court has answered that question, and before disrupting the balance that currently exists, Congress should consider carefully the impact the Bryan Amendment would have on American businesses.

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[49] The October 1987 MARKET BREAK, A Report by the Division of Market Regulation, U.S. Securities and Exchange Commission (Feb. 1988) at xi.

[50] H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 32, 36, 42 (1934); 78 Cong. Rec. 8198–8203 (May 7, 1934); Ellenberger & Mahar, 6 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 6565–66, 6718, 6993 (1973) and 7 *id.* at 7743–44.

[51] *Id.*

[52] *Id.*

[53] *Id.*

[54] *Short* v. *Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied,* 111 S. Ct. 2887 (1991).

Plaintiffs Should Be Required to Use Reasonable Diligence to Detect Signs of Fraud

Courts have applied the principle of "reasonable diligence" to actions brought under Exchange Act Section 10(b) and Rule 10b–5 for decades.[55] This principle starts the clock of the limitations period running when the plaintiff has been presented with sufficient clues so that, through reasonable diligence, he or she should discover that a securities law violation had occurred. To determine whether a plaintiff "should have discovered" a violation, courts have looked at whether (i) sufficient facts were available to the plaintiff to have put a reasonable investor on notice of the possibility that fraud had occurred, and (ii) the plaintiff exercised due diligence in attempting to learn the facts.[56] The principle of "reasonable diligence" is rooted in the doctrine of equitable tolling, a doctrine imposed by courts to allow plaintiffs more leeway when strict statutes of limitations would have expired—the courts would not begin the limitations period until the plaintiff had an opportunity to discover the fraud.[57] This principle seems consistent with SEC Chairman Richard Breeden's concern that Congress should "require investors to assert their rights promptly once they detect signs of fraud."[58]

The Bryan Amendment, as initially drafted, would have incorporated an express "reasonable diligence" standard. As marked up and adopted earlier this summer, however, the Amendment would likely be read to eliminate this principle, instead starting the clock when the plaintiff actually made the discovery. As a result, plaintiffs with notice of the initiation of an SEC enforcement proceeding[59] or private litigation against a defendant,[60] a sharp drop in the market price of an issuer's stock,[61] defaults in bond payments or payments to other creditors,[62] bankruptcy[63] or other indications that a company might be in trouble[64] may, nevertheless, be relieved of any obligation to inquire further. Eliminating the "reasonable diligence" requirement would, in some instances, actually reward plaintiffs aware of facts indicative of fraud for intentionally failing to inquire further, and instead remaining in a state of intentional ignorance for years before taking the steps necessary to determine whether to pursue a claim.

Retroactivity

The developments within the circuits and the Supreme Court decisions relating to statutes of limitations, as indicated earlier in my testimony, left little surprise when the Supreme Court granted *certiorari* in the Lampf case on October 9, 1990, a full 8 months prior to the Supreme Court's decision.[65] Certainly, no one knew what the Supreme Court's decision would be, and even careful practitioners may have been caught by surprise when it was announced. But it had been clear for many months that the Court was examining the statute of limitations for Rule 10b–5 actions and could adopt a restrictive period.

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[55] *See, e.g., Tobacco & Allied Stocks, Inc.* v. *Transamerica Corp.*, 143 F.Supp. 323, 328–29 (D.Del. 1956), *aff'd*, 244 F.2d 902 (3d Cir. 1957).

[56] *Maggio* v. *Gerard Freezer & Ice Co.*, 824 F.2d 123, 128 (1st Cir. 1987). See generally Goldberg, Litigation and Practice under Rule 10b–5, § 235.03 at 10–49 (2d ed. 1991 rev.).

[57] Indeed, one commentator in 1933 reported that 32 State legislatures had adopted statutes providing causes of action for fraud, expressly providing that the limitations period would not begin to run until the fraud had been "discovered." He explained:

> The "discovery" by the plaintiff is everywhere taken to mean something less than actual discovery of the defendant's wrong: the wrong is "discovered" at the point where facts could have been ascertained by using reasonable diligence. This qualification introduces new variables into the arithmetic of the limitation acts, but it seems imperatively required by their larger social purpose and it is functionally related to the equitable doctrine of "laches" from which these exceptions are historically derived.

Dawson, *Undiscovered Fraud and Statutes of Limitations*, 31 Mich. L. Rev. 591, 619 (1933) (citations omitted).

[58] Letter to The Honorable Senator Richard Bryan from Richard C. Breeden, Chairman, SEC (undated) (responding to Senator Bryan's letter dated July 22, 1991).

[59] *See, e.g., Herm* v. *Stafford*, 455 F.Supp. 650, 653 (W.D. Ky. 1978) *rev'd on other grounds* 663 F.2d 669 (6th Cir. 1981).

[60] *See, e.g., Ohio* v. *Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687, 694 (10th Cir. 1981), *cert. denied, 454 U.S. 895 (1981).*

[61] *See, e.g., Gaudin* v. *KDI Corp.*, 576 F.2d 708, 712 (6th Cir. 1978); *Berry Petroleum Co.* v. *Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

[62] *See, e.g., Loveridge* v. *Dreagoux*, 678 F.2d 870, 875 (10th Cir. 1982).

[63] *See, e.g., Herm* v. *Stafford*, 455 F.Supp. 650, 653 (W.D. Ky. 1978), *rev'd on other grounds*, 663 F.2d 669 (6th Cir. 1981).

[64] *See generally* Bloomenthal, *Statutes of Limitations and the Securities Acts Revisited*, 11 Sec. & Fed. Corp. L. Rep. 9 (Feb. 1989) and 17 (March 1989).

[65] *Lampf, Pleva, Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 242 (1990).

It would be unfortunate to encourage a system of lawmaking where persons affected negatively by Supreme Court decisions sought Congressional assistance in overriding the Court's reasoned conclusion. Such a system would do injustice to the notion of finality of judicial decisions. In this instance, it would revive causes of action against defendants who have been freed from liability by judicial decision. Even assuming that no due process concerns would preclude Congressional action in this manner, "retroactivity in civil cases must be limited by the need for finality . . . once suit is barred by res judicata or by statutes of limitation or repose, a new rule cannot reopen the door already closed."[66]

Conclusion

The problems attendant to securities litigation and the concerns prompted by the language of the Bryan Amendment suggest that extending the limitations period for an already troubled cause of action would be counterproductive. Issues such as the possibility of requiring losing parties to pay the legal expenses of parties who prevail in litigation and ensuring that nonsettling defendants will be liable to pay only the percentage of damages resulting from their conduct certainly should be explored. Any adjustment to the remedy afforded investors under Rule 10b–5 should be considered only in the context of a broader analysis of implied private remedies under the Exchange Act.

Again, I thank the Subcommittee for this opportunity to contribute to the legislative process.

LETTER TO SENATOR RIEGLE FROM JOEL SELIGMAN

PROFESSOR, THE UNIVERSITY OF MICHIGAN LAW SCHOOL

APRIL 22, 1994

I am a Professor of Law at The University of Michigan Law School and coauthor with Harvard Law School's Professor Louis Loss of an 11 volume treatise on Securities Regulation, that is widely regarded as an authoritative work in the field. I write as an independent scholar with no affiliation or relationship to any party mentioned in this letter.

Two recent events have focused attention on private Federal securities litigation:

(1) The Supreme Court decision on April 19, 1994 in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*[1] *holding that a private plaintiff may not maintain an aiding and abetting lawsuit under § 10(b) and Rule 10b–5, the principal antifraud provisions of the Securities Exchange Act; and*

(2) The introduction by Senator Dodd and four cosponsors of S. 1976,[2] which, among other proposals would (a) eliminate bonus payments to named plaintiffs;[3] (b) limit attorneys' fees to a percentage of recovery;[4] (c) require special verdicts;[5] (d) limit named plaintiffs to those owning the lesser of 1 percent of the securities subject to the litigation or $10,000 (in market value) of these securities;[6] (e) specify a variety of alternative dispute resolution mechanisms;[7] (f) require the appointment of a guardian ad litem and plaintiff steering committee for the plaintiff class;[8] (g) specify new pleading requirements for securities fraud actions;[9] (h) eliminate civil liability for securities violations of the Racketeer Influenced and Corrupt Organization Act;[10] (i) specify new requirements for the Securities and Exchange Commission (SEC) to consider regulatory or legislative changes to provide safe harbors for forward-looking statements;[11] and (j) substitute proportionate liability for joint and several liability.[12]

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[66] *Beam Distilling Co.* v. *Georgia*, 111 S. Ct. at 2439, 2446 (1991).
[1] —— U.S. ——, 1994 U.S. LEXIS 3120.
[2] Cong. Rec. S. 3696–3704 (March 24, 1994).
[3] § 101(c).
[4] § 101(l).
[5] § 101(n).
[6] § 101(o).
[7] § 102.
[8] § 103.
[9] § 104.
[10] § 105.
[11] § 201.
[12] § 203.

Of these two events, the Supreme Court decision is of vastly greater immediate importance. The elimination of aiding and abetting liability from Rule 10b–5 claims poses a threat to the integrity of the SEC's mandatory disclosure system. I am writing to urge that you support a legislative reversal of the *Central Bank* case and to describe the current debate concerning the need for legislation to restrict private litigation under the Federal securities laws.

I. The Supreme Court Decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.* Should be Legislatively Reversed

The Supreme Court's *Central Bank* decision is the most important Federal securities law decision in several years. In my opinion, it is also one of the most regrettable.

By a 5–4 vote, the Court's majority held that a private plaintiff may not maintain an aiding and abetting lawsuit under § 10(b) or Rule 10b–5.

This was an unexpected result. Last year by a 6–3 vote, the Court had held that it could imply a private right of action under Rule 10b–5 to seek contribution. Musick, Peeler & Garrett v. *Employers Ins. of Wausau, 508 U.S. ——, 113 S. Ct. 2085 (1993).*

The four dissenting justices in *Central Bank* accurately wrote:

> In hundreds of judicial and administrative proceedings in every circuit in the Federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b–5. See 5B A. Jacobs, Litigation and Practice Under Rule 10b–5 §40.02 (rev. ed. 1993) (citing cases). While we have reserved decision on the legitimacy of the theory in two cases that did not present it, all 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b–5.

Significantly there appears to be no principled basis to avoid Federal courts also holding that the SEC may not bring § 10(b) and Rule 10b–5 claims for aiding and abetting, or the holding that other derivative liability theories such as *respondeat superior* are not permissible in either private or SEC actions. As the four dissenting Justices wrote: "The majority leaves little doubt that the Exchange Act does not permit the Commission to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b–5. Aiding and abetting liability . . . has become an important part of the Commission's enforcement arsenal. Moreover, the majority's approach to aiding and abetting at the very least casts serious doubt, both for private and SEC actions, on other forms of secondary liability that, like the aiding and abetting theory, have long been recognized by the SEC and the courts but are not expressly spelled out in the securities statutes."

As the four dissenting Justices state, aiding and abetting liabilities under § 10(b) and Rule 10b–5 is "an important part of the Commission's enforcement arsenal." This theory has often been the primary or the exclusive basis for holding accountants liable for recklessly performed audits of securities issuers' financial statements.

In recent years, there has been a disturbing increase in "audit failures." Between 1970 and 1992, the SEC, for example, brought 120 Rule 2(e) disciplinary proceedings against accountants.[13] In 1993 alone, the SEC brought 22 Rule 2(e) proceedings against accountants.[14]

William R. McLucas, the SEC's Director of the Division of Enforcement testified to the Senate Subcommittee on Securities in June 1993: "Last year, 69 of the Commission's approximately 395 enforcement actions primarily involved financial disclo-

[13] 10 L. Loss & J. Seligman, Securities Regulation 4804–4806 n.62 (1993).

[14] See Robert J. Iommazzo, AAER 437, 53 SEC Dock. 473 (1993); Phillip R. McElhaney, CPA, AAER 445, 53 SEC Dock. 1791 (1993); Phillip C. Zarcone, AAER 450, 54 SEC Dock. 125 (1993); Gordon H. Flattum, AAER 451, 54 SEC Dock. 359 (1993); Donald D. Hinkle, AAER 453, 54 SEC Dock. 649 (1903); K. Clark Childers, AAER 455, 54 SEC Dock. 759 (1993); Thomas V. Curtin, CPA, AAER 458, 54 SEC Dock. 859 (1993); James Burton, CPA, AAER 462, 54 SEC Dock. 949 (1993); Robert R. Berti, AAER 465, 54 SEC Dock. 1134 (1993); Bernard Tarnowsky, AAER 467, 54 SEC Dock. 1168 (1993); Michael J. Walsh, AAER 476, 54 SEC Dock. 1712 (1993); Charles Ferguson, AAER 477, 54 SEC Dock. 1787 (1993); Martin G. Browne, AAER 479, 54 SEC Dock. 1991 (1993); Gregory J. Melsen, AAER 482, 55 SEC Dock. 35 (1993); Arnold M. Gotthilf, AAER 485, 55 SEC Dock. 201 (1993); Stanley Siegel, CPA, AAER 486, 55 SEC Dock. 215 (1993); William V. Burnes, AAER 487, 55 SEC Dock. 217 (1993); Fred V. Schiemann, CPA, AAER 488, 55 SEC Dock. 225 (1993); John J. Mohalley, CPA, AAER 489, 55 SEC Dock. 245 (1993); Joseph F. Murphy, CPA, AAER 496, 55 SEC Dock. 398 (1993); Gordon K. Goldman, CPA, AAER 497, 55 SEC Dock. 406 (1993); Arthur J. Dellinger, Jr., CPA, AAER 511, 55 SEC Dock. 1618 (1993).

sure or accounting issues. These types of cases averaged roughly 15 percent of the enforcement actions brought by the Commission over the last 10 years."[15]

Audit failure are not limited to small accounting firms. In 1992, Ernst & Young agreed to pay $400 million to settle United States regulatory agency claims against it for audits of four failed thrift institutions.[16] During the same year Coopers & Lybrand agreed to pay $95 million to settle claims related to MiniScribe[17] and in 1994 Deloitte & Touche agreed to pay $312 to settle civil fraud claims arising from the failure of Lincoln Savings & Loan.[18]

More general data were provided to the Senate Securities Subcommittee by counsel to the Big Six accounting firms. Between 1990 and 1992, private litigation produced the following results:[19]

(A) AUDIT-RELATED CASES CONTAINING ANY FEDERAL SECURITIES LAW CLAIMS, INCLUDING RULE 10b-5 CLAIMS*

	1990	1991	1992
Total Amount of Awards and Settlements Paid	$58.5M	$87.5M	$373.9M
Amount of Awards and Settlements per Audit Partner	$12,968	$20,686	$92,298
Number of Cases Settled	12	27	37
Amount of Settlements	$36.5M	$79.5M	$373.9M
Number of Cases Dismissed	7	11	25
Number of Cases Tried	1	4	0
Number of Verdicts for Defendants	0	3	0
Number of Verdicts for Plaintiffs	1	1	0
Total Amount of Awards to Plaintiffs	$22M	$8M	$0

* Includes all cases containing any federal securities law claim, even if other federal or state claims were also alleged in the complaint.

In aggregate, these data suggest that the Big Six accounting firms paid a total of $373.9 million to settle 37 securities claims in 1992. This total was dramatically greater than the $58.5 million paid for damages awards and settlements in 1990, or the $87.5 million paid in 1991. These data are striking also in that the average settlement in 1992 amounted to approximately $10 million, which is well in excess

[15] Private Litigation under the Federal Securities Laws, Hearings before Subcommittee on Securities, Senate Committee on Banking, Housing, & Urban Affairs, 103d Cong., 1st Sess. 112 (1993).

[16] Bacon & Berton, Ernst to Pay $400 Million over Audit of 4 Big Thrifts, Wall St. J., Nov. 24, 1992, at D1; Labaton, $400 Million Bargain for Ernst, New York Times, Nov. 25, 1992, at A3; Dingell, Markey & Wyden, "Where Were the Auditors?", Wash. Post, Dec. 25, 1992, at —— ("Earlier this year, the Federal Deposit Insurance Corporation and the Resolution Trust Corporation had 35 suits pending against accounting firms with nearly $3 billion in potential claims.").

[17] Harlan, Coopers & Lybrand Agrees to Payment of $95 Million in the MiniScribe Case, Wall St. J., Oct. 30, 1992, at ——.

[18] Jefferson & Burton, Accounting Firm to Settle Suit to Thrift, Wall St. J., March 17, 1992, at A4. Ernst & Young also paid $63 million in this case. Stevens, Ernst & Young, and Jones Day Law Firm to Pay $87 Million in Lincoln S&L Case. Wall St. J., March 31, 1992, at ——.

[19] Private Litigation under the Federal Securities Laws, supra n.15, at 734 (letter to SEC from Mayer, Brown & Platt, Sept. 24, 1993).

of what one might assume would be paid to settle "nonmeritorious" or "frivolous" litigation.

The Supreme Court's *Central Bank* decision will eliminate accounting liability in private and probably SEC actions for aiding and abetting under § 10(b) and Rule 10b–5, the principal antifraud provisions of the Federal securities laws. This will significantly reduce the deterrent effect of these provisions. The pressure on accountants to perform audits of the highest possible quality will be reduced at precisely the same time there appears to be some deterioration in audit quality.

The basic concern I have about the *Central Bank* decision is that it may jeopardize investor confidence in United States securities markets.

One reason that the United States has achieved its current success in capital formation and breadth of securities ownership is the Federal securities laws' mandatory disclosure system, as enforced by Government and private litigation. It is significant, I believe, that the United States both has the broadest stock ownership and the most demanding disclosure system.[20] The mandatory disclosure system has performed a significant role in maintaining investor confidence in the securities markets and deterring securities fraud.[21]

If we reduce further the reliability of mandatory disclosure to investors, we run significant economic risks. We may surrender, in part, a comparative advantage we have long held over competitive foreign securities markets. We may increase the incidence of false and misleading financial statements because there are relaxed incentives for accountants to detect fraud in audits of financial statements. We may ultimately reduce aggregate securities prices because of the financial costs of fraud.

Accordingly I strongly urge you to support legislation that will establish an SEC and private right of action under § 10(b) to seek aiding and abetting liability. I believe that the principal earlier claim of the accounting profession (that liability should be proportionate) should also be considered when hearings are held on this legislative proposal.[22]

II. There is Otherwise Little Evidence Demonstrating the Need for New Legislation

Underlying the debate concerning whether the procedures of private litigation under the Federal securities laws should be further restricted is a fundamental question: Is there any need for new legislation? Even the Chairman of the Senate Securities Subcommittee, who has lent his name to a legislative proposal, has expressed doubt as to whether he can persuasively answer this question.[23] In my opinion, matters are not so mysterious. With limited exceptions,[24] there is insufficient evidence at this time to justify legislative changes that will further burden private Federal securities litigation. While there may be a few peripheral questions that deserve further legislative investigation, the basic case for far reaching new legislation has not been made.

The proponents of new legislation essentially base their case on four types of arguments:

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[20] See 2 L. Loss & J. Seligman, Securities Regulation 792–801 (1989 & 1993 Ann. Supp.).

[21] 1 Id. 171–225.

[22] "Accountants say they are automatically joined as defendants because of their deep pockets and that they may be held liable for a disproportionate share of the actual losses." Private Litigation under the Federal Securities Laws, supra n.15, at 2 (statement of Senator Christopher J. Dodd); *accord:* id. at 3 (statement of Senator Donald W. Riegle: "The accounting profession also criticizes the way liability for securities fraud is assessed. Under joint and several liability, an investor who's been defrauded may recover his or her entire loss from any one defendant, even if others orchestrated the fraud.").

[23] See statement of Senator Dodd, id. at 280:

Consequently, after a long hearing that lasted well into the afternoon, we found no agreement on whether there is in fact a problem, the extent of the problem, or the solution to the problem. In my experience with this Subcommittee, I've never encountered an issue where there is such disagreement over the basic facts. We often argue about policy, we argue about ideology, we often argue about politics, but it is rare that we spend so much time arguing about basic facts.

[24] There was testimony presented to the Senate Securities Subcommittee that some plaintiffs' class representatives were paid a bonus for allowing attorneys to use their names as class representatives. Id. at 344 (statement of Senator Dominici estimating bonus to be $10,000 to $15,000); id. at 467 (written response to question from plaintiff's attorney Melvyn I. Weiss: "My firm occasionally participates in a request that the court award a payment to the named plaintiffs of up to $15,000. We do this to provide some compensation for the class representatives for the inconvenience, time spent, and expense incurred by them while serving as class representatives."). Cf. concern expressed by Senator Mikulski about this practice in Cong. Rec. S.3707 (March 24, 1994).

I do not believe that there is a persuasive rationale for this type of practice. Simply put, the old fashioned notion that clients hire lawyers; lawyers don't hire clients, retains some validity in even the class action context.

(A) "[S]ecurities litigation has gotten out of hand and is destroying the every capital formation policy it seeks to promote."[25] For example, "companies can become more reluctant to take business risks, for each time a risk fails, we are subject to a suit for fraud."[26]

For all the emotional appeal of arguments that excessive litigation is destroying capital formation, existing data illustrate a quite different picture. In 1992 the Securities and Exchange Commission reported in its Annual Report:

> Despite general economic conditions, the total dollar amount of securities filed for registration with the SEC during 1992 reached a record of over $700 billion, a 40 percent increase from the approximately $500 billion registered last year. The number of issuers accessing the public markets for the first time soared, with Initial Public Offering (IPO) filings of equity or debt reaching $66.5 billion, an increase of about 53 percent from the $43.6 billion filed in 1991.[27]

In 1993 the Commission reported even more impressive results:

> The decline in interest rates, the burgeoning need for capital for businesses, small and large, and investor demand helped to fuel a record level of offerings filed for registration in 1993. More than $868 billion in securities were filed for registration, including over $112 billion of initial public offerings, equity and debt, and over $46 billion by foreign companies.[28]

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[25] Private Litigation under the Federal Securities Laws, Hearings before Subcomm. on Sec., supra n.15, at 2 (statement of Senator Dodd); *accord:* Id. at 3 (statement of Senator Riegle: Because companies may settle regardless of the merits: "This raises the cost of capital formation and [puts] our firms often at a competitive disadvantage."); id. at 12 (statement of Edward R. McCracken, President, Silicon Graphics, Inc.: "[A]n uncontrolled tax on innovation"); id. at 37 (statement of William R. McLucas, Director, SEC Division of Enforcement: "The SEC has acknowledged the detrimental impact of meritless securities cases. To the extent that these claims are settled to avoid litigation, they impose a tax on capital formation"); id. at 105 (statement of John G. Adler, President, Adaptec, Inc., criticizing "the adverse effect of abusive securities suits on American competitiveness"); id. at 109 (statement of Richard J. Egan, Chairman, EMC Corp., on implications for public companies, investors, and the U.S. economy); id. at 417–418 (statement of Marc E. Lackritz, President, Securities Industry Association).

[26] Id. at 17 (statement of Richard J. Egan, Chairman, EMC Corp.); see generally at 18 ("Companies will not take sound risks, but will manage their operations so as to maintain steady performance and avoid stock fluctuations").

There were polling data that amplified this argument. According to an undated American Business Conference poll, paraphrased by Senator Domenici id. at 346:

- 75 percent [apparently of outside directors] said that 10(b)(5) litigation is affecting their ability to compete.
- 81 percent said that they are spending increasing amounts of time on litigation and that the commitment has doubled in the last 5 years.
- 26 percent said that the threat of litigation has led to a policy of not serving on the boards of start up firms.
- 49 percent of the settlements went to the plaintiffs' attorneys.

There was also a derivative argument here. "[R]eluctance on the part of the accounting profession to audit growing companies for fear of liability is also restraining capital formation." Id. at 4 (statement of Senator Riegle); cf. the data that were cited id. at 348, by Jake L. Netterville, the Chairman of the Board of Directors of the American Institute of Certified Public Accountants (AICPA):

> In recent years, growing numbers of smaller accounting firms have stopped performing audits. A recent survey of California CPA firms revealed that only 53 percent are willing to undertake audit work, while, of those, 32 percent are discontinuing audits in what they consider to be high-risk economic sectors. Similarly, a study by insurance consultants Johnson & Higgins found that 56 percent of the midsized accounting firms surveyed will not do business with clients in industries the firms judge high-risk.

[27] SEC Ann. Rep. 52 (1992).

[28] SEC Ann. Rep. 51 (1993). The Senate Securities Subcommittee reported further evidence of the buoyancy of United States capital markets. In Private Litigation under the Federal Securities Laws, supra n.15, at 157 & 159, charts were published illustrating the growth in initial public offerings and common stock offerings between 1973 and 1992. E.g.:

	1973	1983	1992
Number of Initial Public Offerings	96	686	603
Dollar Proceeds (in billions)	$1.4	$12.5	$40.0
Number of Common Stock Offerings	293	1,509	1,085
Dollar Proceeds (in billions)	$6.2	$38.7	$72.8

Even the Securities Industry Association, a proponent of new legislation to restrict Federal securities class actions, took pride in the recent effectiveness of capital formation. The SIA president, for example, testified to the Senate Securities Subcommittee: "In 1992, the securities industry raised over $1 *trillion* for corporations through bond and note sales, setting a new record. That is more than double the amount raised in any year prior to 1989. SIA firms also raised $128 billion in public and private stock issues."[29]

At present, there is a high level of investor confidence in the integrity of United States securities markets. According to the New York Stock Exchange, in 1990, over 51 million United States citizens directly owned corporate stock,[30] with tens of million more owning stock *indirectly* through institutional investors which in aggregate held over $2 trillion in equity securities in 1992.[31]

Private litigation performs a significant role in maintenance of investor confidence by enforcing the mandatory disclosure system. Former SEC Chairman David Ruder noted in 1989, that in recent years less than 10 percent of cases involving securities or commodities have been brought by the Government.[32]

William R. McLucas, the SEC's Enforcement Division Director, significantly amplified Ruder's point:

> Due to the Commission's inability to address all violations, the implied private right of action under Section 10(b) and Rule 10(b)(5) thereunder is critically important to the effective operation of the Federal securities laws. As the Supreme Court has stated repeatedly over the last 30 years, private actions under the Federal securities laws are a "necessary supplement" to the Commission's own enforcement activities.[33] Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.
>
> Private securities fraud actions also serve another important function that Commission enforcement actions cannot replace. When the Commission files an enforcement action, its principal objectives are to enjoin the wrongdoer from future violations of the law to deprive violators of their profit by seeking orders of disgorgement, and generally to deter other violations by seeking civil money penalties. Although the Commission usually makes disgorged funds available for the compensation of injured investors, the amount of investor losses often exceeds the wrongdoer's ill-gotten gains. Private actions, by contrast, enable defrauded investors to seek compensatory damages and thereby recover the full amount of their losses.[34]

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[29] Id. at 413 (statement of Marc E. Lackritz).

[30] N.Y. Stock Exch., Fact Book 70 (1992).

[31] Id. at 28.

[32] Ruder, The Development of Legal Doctrine through Amicus Participation: The SEC Experience, 1989 Wis. L. Rev. 1167, 1168.

[33] McLucas cited four Supreme Court cases: *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 309 (1985); *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 2773, 2789 (1991).

[34] Id. at 113–114. Cf. id. at 145, quoting former SEC Chairman Richard Breeden's letter to Senator Terry Sanford, Aug. 12, 1992, at 1:

> Private suits under Section 10(b) of the Securities Exchange Act and Rule 10(b)(5) thereunder . . . are instrumental in recompensing investors who are cheated through the issuance of false

On the basis of these types of data and testimony, there appear to be only undocumented assertions that litigation in some way has impeded capital formation. Specifically there were no cases offered of a corporation with a meritorious stock offering being unable to sell securities to investors.

(B) The proponents of new legislation to restrict private litigation under the Federal securities laws also urge that: "Companies, particularly growth firms, say they are sued whenever their stock drops."[35]

Several witnesses at 1993 Senate Subcommittee hearings on Private Litigation under the Federal Securities Laws testified that "companies can be exposed to potential litigation whenever the stock price falls by approximately 10 percent, even if there's absolutely no violation of security laws or fiduciary responsibility."[36] In the most extreme of these claims, one business executive testified that decisions to sue were computer generated. "I think that what happens, if the stock drops more than 10 percent, irrespective of the reason, without the facts, the computer just says, these are the stocks that dropped 10 percent. So, therefore, we ought to take the complaint that we have on the computer and just bring it up and put the names in."[37]

The frequency of Federal securities class action litigation was a much investigated topic at the 1993 Senate Securities Subcommittee hearings.[38]

Attached to the testimony of William R. McLucas, Director of the Commission's Division of Enforcement, was a much quoted Appendix A (see chart below), based

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and misleading information or by other means. When corporate officers, accountants, lawyers or others involved in the operation of a public company deceive investors for their own benefit, they should be held accountable for their actions. If this were not the case, investors would be far less willing to participate in our securities markets. This would limit the most important source, and raise the costs, of new capital for all American businesses.

[35] Id. at 3 (statement of Senator Riegle); *accord:* id. at 5 (statement of Senator Domenici: "We're going to hear from witnesses that know first-hand how [Rule 10b–5] lawsuits can be filed within weeks, sometimes days, or even in hours after a stock drops in price."); id. at 14–15 (statement of John G. Adler: "The price of the stock drops on some unforeseen, but not ordinary business event"); id. at 16 (statement of Richard J. Egan, Chairman, EMC Corp: Strike suits "are typically filed within days or sometimes hours of a company's announcement of adverse news and disappointing earnings").

[36] Id. at 12 (statement of Edward R. McCracken); see id. at 12–13 (anecdote about experience of McCracken's corporation, Silicon Graphics, Inc.); id. at 19 (statement of Thomas Dunlap, Jr. referring to "automatic" 10 percent rule); id. at 871–875 (letter from Milberg Weiss Bershad Hynes & Lerach, Aug. 19, 1993, quoting a series of testimonial statements about 10 percent stock drops).

[37] Id. at 24 (statement of Thomas Dunlap, Jr.).

[38] On this point, there was a certain amount of naive data presented by defenders of the current system. A leading plaintiffs' law firm requested an economics expert witness firm to calculate the number of times a public traded company trading on the New York Stock Exchange, the American Stock Exchange or NASDAQ fell by more than 10 percent on any one day between 1986–1992 and compare the number of class action suits filed. The results were summarized in the following table:

YEAR	10% STOCK DROPS (all occurrences)	CLASS ACTION SUITS FILED	% SUED
1986	2,773	118	4.2
1987	10,801	108	0.9
1988	2,514	108	4.2
1989	2,263	118	5.2
1990	4,679	315	6.7
1991	4,119	299	7.2
1992	6,030	268	4.4
	33,206	1,584	4.7

Id. at 876 (letter of Milberg Weiss Bershad Hynes & Lerach, Aug. 19, 1993).

Superficially these data suggest that in only about one in every 20 or so 10 percent stock drops would a suit be brought. But neither number being compared is particularly well chosen. If a stock price dropped 10 percent one day and recovered most or all of the drop in price before a suit was filed, the purported predicate for the lawsuit would be removed. The data overstate also the number of companies actually sued. Since a given event can trigger multiple suits that will be subsequently consolidated, the number of suits filed is not a useful indicator. The real issue, as developed in the text, is the number of suits after consolidation, or as one commentator phrased it, the number of companies sued.

on data from the Administrative Office of the United States Courts, summarizing court civil filings in United States District Courts between 1971 and 1992:[39]

CIVIL FILINGS IN UNITED STATES
DISTRICT COURTS, 1971-1992

Data supplied by Administrative
Office of the United States Courts

Fiscal Year	Total Civil Filings U.S. District Court	Securities, Commodities & Exchanges District Filings	Securities, Commodities & Exchanges # Pending	Total Class Action Filings	Securities, Commodities & Exchanges District Filings	Securities, Commodities & Exchanges # Pending
1971	93,396	1,962	N/A	N/A	N/A	N/A
1972	96,173	1,919	N/A	N/A	N/A	616
1973	98,560	1,999	3,689	2,654	235	631
1974	103,530	2,378	4,033	2,717	305	727
1975	117,320	2,408	4,280	3,061	258	713
1976	130,597	2,230	4,392	3,538	212	N/A
1977	130,567	1,960	4,206	3,153	176	670
1978	138,770	1,703	3,824	2,586	167	640
1979	154,666	1,589	3,436	2,084	100	521
1980	168,789	1,694	3,058	1,568	87	426
1981	180,378	1,768	2,919	1,672	86	345
1982	206,316	2,376	3,304	1,238	151	318
1983	241,842	2,915	3,919	1,023	133	312
1984	261,485	3,142	4,505	988	149	329
1985	273,670	3,266	5,082	971	140	318
1986	254,828	3,059	5,221	736	118	290
1987	239,185	3,021	5,327	610	108	290
1988	239,634	2,638	4,894	742	108	296
1989	233,529	2,608	4,507	647	118	274
1990	217,879	2,629	4,613	922	315	433
1991	207,690	2,198	4,555	930	299	617
1992	226,895	1,998	4,137	1,196*	268*	642*

* Class action data is as of the fiscal year ending September 30, 1992

There were two quite different types of implications that could be inferred from these data. From a pro-plaintiff perspective, it could be urged that the number of securities and class filings has not increased because, for example, there were only 108 filings in 1987 and 1988, and 268 filings in 1992. From a pro-defendant perspective, the opposite argument can be made that the number of lawsuits has dramatically increased because there were only 108 filings in 1987 and 1988 and 268 in 1992.

Both of these types of implications are wrong. As James M. Newman, publisher and editor of the *Securities Class Action Alert,* accurately testified before the Senate Securities Subcommittee:[40]

> The problem is that numerous suits based on the same or similar allegations are being filed against the same company. The vast majority of these "look alike" suits are eventually consolidated into one suit. For example in 1990, Oracle Systems Corporation was named in 16 similar suits all filed from March 29, 1990 through April 13, 1990. On April 29, 1990, Judge Vaughn R. Walker of the Northern District of California consolidated all 16 cases into one. Sixteen cases were counted in the statistics used in supporting the erroneous notion of a substantial increase in shareholder's suits.
>
> Thus, the real measure of the level of litigation activity can only be determined by counting the number of companies sued in distinct class action suits.
>
> The number of *companies* sued is substantially smaller than the number of suits filed as shown in the following table. (The year represents the Fiscal Year ending September and is used to conform to the data published by the Administrative Office of the United States Courts.)

[39] Id. at 121.
[40] Id. at 777.

	1989	1990	1991	1992
Number of Suits Reported by Administrative Office of U.S. Courts	169	326	256	265
Number of Companies Sued*	108	151	122	113
*May be increased by these unidentified suits	4	4	5	0

These data indicate that approximately 123.5 consolidated suits were filed per annum between 1989 and 1992. This is hardly the litigation explosions suggested by proponents of new legislation[41] and should be compared to the greater than 17,400 companies that annually file with the SEC (including 4,000 investment companies)[42] and greater than 3 million business corporations that file Federal income tax returns in the United States.[43]

Moreover even a cursory review of litigation in this field makes clear that the Federal courts regularly dismiss before trial complaints whose sole substance is a description of a stock drop.[44] The leading treatise on Federal civil procedure has categorically written that to survive dismissal on the basis of a factually insufficient complaint there "must be detailed . . . averments such as the time, place, the identity of the parties involved, and the nature of the fraud . . ."[45] "Federal securities claims have been dismissed when they were "mere conclusory allegations to the effect that defendant's conduct was fraudulent or in violation of Rule 10b–5,"[46] or that defendant's reports presented a "false, misleading, and inflated picture of assets, earnings, and business."[47]

(C) The proponents of new restrictive legislation also urge that none of the judiciary's devices to discourage frivolous litigation such as Rule 9(b) which permits dismissal on the basis of an inadequately pleaded complaint, or Rule 11 which authorizes sanctions for filing a complaint in bad faith, successfully winnow out nonmeritorious lawsuits.[48]

There were data available to the Senate Subcommittee on Securities that suggest the facts are quite different. Senator Domenici, for example, summarized the litigation experience of a leading—if not *the* leading—plaintiff's litigation firm which in 1990 and 1991 filed 111 cases, and found that 38 percent were dismissed on a mo-

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[41] Indeed Senator D'Amato was astonished that only 268 cases were filed in 1992. "[That) number doesn't seem like an explosion . . ." Id. at 31. He added at 32: "Overall though, 268 such cases filed nationwide is far different than the picture described—that whenever there is a glitch in the market, everybody is the subject of a frivolous securities suit and that since it only costs $120 to file the suit companies can be blackmailed into paying a settlement."

[42] Id. at 341 (statement of A. A. Sommer, Jr., Chairman, Public Oversight Board, AICPA).

[43] Statistical Abstract of the United States Table No. 847 (1992) (listing 3.623 million business corporations in 1989).

Rule 10b–5 litigation can be initiated against a business regardless of its size.

[44] *See, e.g., DiLeo* v. *Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) ("Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud."); *Romani* v. *Shearson Lehman Hutton, 929 F.2d 875, 878 (1st Cir. 1991) ("We have been especially rigorous in demanding such factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement, rather than in the hopes that the process will reveal relevant evidence.'"); O'Brien* v. *National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991) (An ample factual basis must be supplied to demonstrate or provide a "strong inference" that defendants' conduct was a product of "fraudulent intent." "Essentially, while Rule 9(b) permits scienter to be demonstrated by inference, this 'must not be mistaken for license to base claims of fraud on speculation and conclusory allegations.'")

[45] 5 C. Wright & A. Miller, Federal Practice and Procedure § 1241 at 295 (1990).

[46] *See, e.g., Shemtob* v. *Shearson Hammill & Co.*, 448 F.2d 442, 444 (2d Cir. 1971); *Segal* v. *Gordon*, 467 F.2d 602, 606 (2d Cir. 1972); *Felton* v. *Walston & Co.*, 508 F.2d 577, 580 (2d Cir. 1974); *Denny* v. *Barber*, 576 F.2d 465, 469 (2d Cir. 1978); *Decker* v. *Massey-Ferguson, Ltd.*, 681 F.2d 111, 114 (2d Cir. 1982); *Semegen* v. *Weidner*, 780 F.2d 727, 731 (9th Cir. 1986); *Moore* v. *Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989) ("While statements of the time, place, and nature of the alleged fraudulent activities are sufficient, mere conclusory allegations of fraud are insufficient"); *Farlow* v. *Peat, Marwick, Mitchell & Co.*, 956 F.2d 982 (10th Cir. 1992); *Greenstone* v. *Cambex Corp.*, 975 F.2d 22, 25–27 (1st Cir. 1992).

[47] *Decker* v. *Massey-Ferguson, Ltd.*, 681 F.2d 111, 115 (2d Cir. 1982).

[48] Private Litigation under the Federal Securities Laws, supra n.15, at 30–31 (statements criticizing ineffectiveness of Rule 9(b) and 11).

tion, with all of the balance subsequently settled.[49] Similarly the Big Six accounting firms reported that in private Federal securities litigation against these firms between 1990 and 1992:

	1990	1991	1992
Number of Cases Settled (%)	12 (57%)	27 (59%)	37 (60%)
Number of Cases Dismissed (%)	7 (33%)	11 (24%)	25 (40%)
Number of Cases Tried (%)	1 (5%)	4 (9%)	0 -
Number of Verdicts for Defendants (%)	0 -	3 (7%)	0 -
Number of Verdicts for Plaintiffs (%)	1 (5%)	1 (2%)	0 -
Totals	21	46	62[50]

And the Securities Industry Association reported that in 1992, 46 motions to dismiss for failure to meet the requirements of Rule 9(b) were filed; 29 lawsuits were dismissed.[51] That is 63 percent of the motions to dismiss filed were successful.

Collectively these data suggest that in 1992 approximately 40 percent of all Federal securities class actions filed were dismissed on a motion before trial. One may reasonably infer from such data that the courts are highly effective in winnowing out nonmeritorious lawsuits.

It is also clear that in recent years Federal district courts have increased their willingness to sanction plaintiffs' attorneys for frivolous litigation under § 11(e) of the Securities Act, Rule 11 of the Federal Rules of Civil Procedure, and related standards.[52] In 1993 Rule 11 was amended by the Supreme Court to place "greater constraints on the imposition of sanctions" and to "reduce the number of motions for sanctions to the court" because of a concern that this Rule had been excessively used.[53] Rule 11 remains nonetheless available to sanction the filing of "frivolous" or "bad faith" complaints.

To put matters simply, the Federal district courts under the current regimen of rules are fully capable of dismissing and sanctioning nonmeritorious Federal securities class actions.[54]

There is a more profound response to the argument that procedural devices such as Rules 9(b) and 11 of the Federal Rules of Civil Procedure have not sufficiently curtailed nonmeritorious suits. Judicial construction of substantive law of § 10(b)

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[49] Cong. Rec. S. 3706 (Mar. 24, 1994).

[50] Private Litigation under the Federal Securities Laws, supra n.15, at 734 (letter to Senate Securities Subcommittee from Mayer, Brown & Platt, Sept. 24, 1993).

[51] Id. at 549 (letter from Marc E. Lackritz, President, SIA).

[52] See 10 L. Loss & J. Seligman, Securities Regulation 4644–4654 (1993); Frum, Shoot the Hostages, *Forbes* Dec. 21, 1992 at 138 ("in 1989 alone Rule 11 was invoked some 6,500 times in Federal courts").

[53] Amendments to the Federal Rules of Civil Procedure and Forms, 146 F.R.D. 401, 584 (1993).

[54] Cf. the Statement of SEC Commissioner Richard Roberts quoted in Private Litigation under the Federal Securities Laws, supra n.15, at 143:

> While I do believe that meritless securities litigation is a problem, I am not a supporter of the current legislative attempts to achieve securities litigation reform. I prefer the reform that is *already* taking place judicially. Rule 11 sanctions are now beginning to be level led by courts against both plaintiffs and defendants for taking meritless positions. Further, if certain amendments to the Federal rules of civil procedure are adopted as recommended by the Federal judiciary, Rule 11 will probably be invoked even more frequently. Moreover, the Supreme Court recently has narrowed the application of the civil liability provisions of RICO and has affirmed the right of defendants to seek contribution from persons who were jointly responsible with them for securities law violations.
>
> These reforms, already taking place within the parameters of our existing litigation system, make a lot more sense to me than the well-intentioned but misguided legislative vehicles currently being bounced around. I would rather encourage continued progress on the judicial reforms underway than to engage in the ill-fated legislative pursuit of such worn tort reform concepts as a loser pays rule or a comparative negligence standard.

and Rule 10b–5 of the Securities Exchange Act has substantially reduced the scope of permissible litigation.

Even before the Supreme Court's 1994 decision in *Central Bank of Denver, N.A.* v. *First Interstate Bank of Denver, N.A.*[55] held that there was no private aiding and abetting liability under Securities Exchange Act § 10(b), the Court had long, narrowly construed the contours of that Section. Notably, the Court had held:

(1) Private standing under § 10(b) and Rule 10b–5 is limited to actual purchasers or sellers.[56]

(2) A private claim for damages under § 10(b) and Rule 10b–5 may not lie in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant. An allegation of negligence is insufficient. The Court reserved and continues to reserve the question of whether recklessness will suffice.[57]

(3) A breach of fiduciary duty alone will not violate § 10(b) and Rule 10b–5. There must be proof of fraud.[58]

(4) More recently, in 1991, the Supreme Court adopted an one year after discovery and three years after violation statute of limitation for Rule 10b–5 litigation that typically shortened the earlier applicable limitations period.[59]

(D) Finally proponents of new restrictive legislation have emphasized: "As the cost of defending such suits is high, companies may settle regardless of the merits."[60]

There were two quite different types of claims made to support this argument. First, a number of commentators made the inaccurate assertion that well over 90 percent of Federal securities class actions settle.[61] This type of assertion is flatly wrong. As I earlier illustrated in recent years, approximately 40 percent of Federal securities class actions have been resolved by a judicial dismissal on the basis of a defendant's motion.[62]

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[55] 1994 U.S. LEXIS 3120 (1994).

[56] *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

[57] *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

[58] *Santa Fe Indus., Inc.* v. *Green*, 430 U.S. 462 (1977).

[59] *Lampf, Pleva, Lipkind, Prupis & Petigrow* v. *Gilbertson*, 501 U.S. 350 (1993).

[60] Private Litigation under the Federal Securities Laws, supra n.15, at 3 (Statement of Riegle); *accord:* at 12–13 (anecdote about "completely meritless case" against Silicon Graphics, Inc.); id. at 283 (statement of Senator Domenici: "I believe good cases and bad cases are settled, and I think a real in-depth analysis would say there isn't much difference in the settlements, because a company ends up deciding that they can't gamble on a jury in this kind of complicated issue, and they settle").

A panoply of related points was articulated by the president of the Securities Industry Association: Studies show that these cases have a high probability of settlement regardless of the merits. Why do issuers and other defendants want to settle these cases? Because the cost of defending them is prohibitive. Plaintiffs' lawyers profit when they win a case, and face little risk for merely filing a suit. The lawyers lob barrages of computer-generated pleadings and discovery requests the defendants must satisfy.

Corporations, underwriters, broker/dealers, and accountants often conclude that, even if they could win a case on a motion for summary judgment, the cost of paying sophisticated counsel, the lost time from productive work, and the other risks of litigation simply do not make fighting cost effective; so, the parties settle.

Id. at 317 (statement of Marc E. Lackritz); see also id. at 9–10 (anecdote of Senator Robert F. Bennett); at 19–20 (statement of Thomas Dunlap, Jr. regarding discovery costs).

[61] Id. at 22 (statement of John G. Adler: "[M]y understanding is the statistics show that 96 percent of the cases settle for money and never get to trial"); id. at 24 (statement of Senator Domenici: "There's a 97 percent chance there will be a settlement payment"); id. at 59 (Senator Domenici repeated 97 percent settlement rate).

[62] See supra at 5, 18–19. At most over 90 percent of securities class actions that survive a motion to dismiss are settled. Cf. Private Litigation under the Federal Securities Laws, supra n.15, at 85 (statement of William S. Lerach: "It may be that 95 percent of all securities class actions that aren't dismissed under rule 12(b)(6), that aren't dismissed under rule 9(b), and that survive summary judgment settle, but that wouldn't surprise me and I don't think it would surprise anyone else.")

The reasons why so high a percentage of plaintiffs' claims that survive a motion to dismiss are settled is more a product of defendants' preferences than plaintiffs' bad faith. As counsel to the Big Six accounting firms, I believe, accurately wrote:

Many defendants are forced into pre-trial settlements that deny them a judgment on the merits because, economically, they cannot bear the costs and risk of losing in the face of three very large risks inherent in the current system. Those risks are: punitive damages, a lack of proportionate liability, and juries who may have grossly inflated and erroneous perceptions of the availability of insurance and the ability of businesses to pay large judgments.

Id. at 670 (letter from Mayer, Brown & Platt, June 11, 1993).

Or as a plaintiff's attorney, William S. Lerach, put it:

Good cases produce good recoveries. Securities class actions have produced many large recoveries for victims all over the United States. *WPPSS*—$700+ million; *Lincoln Savings*—$200 mil-

Continued

Second, and far more significant, the assertion was made that settlements often represent a trivial percentage of the potential damages. This datum was cited to support the argument that the "merits do not matter."[63] Most securities class actions, it was urged, were, in essence, strike suits settled for less than the cost of defending them with a substantial portion of the settlement amount paid to the plaintiffs' attorney.[64]

In the most extreme form of this critique the plaintiff's attorney in Federal securities class actions was excoriated as "entrepreneurial"[65] or a "faithless champion" of a plaintiff class.[66]

This proved to be the most controversial issue in the Senate Securities Subcommittee hearings. There were several studies offered by both sides. I find serious methodological deficiencies in all of these studies, both those offered for the proponents and those offered by the opponents of new legislation.

Proponents of more restrictive legislation primarily emphasized three studies:

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lion; *Shell Oil*—$183 million; *L.A. Gear*—$50+ million; *U.S. Financial*—$50 million; *Financial Corp. of America*—$32 million; *Wickes*—$32 million; *VMS*—$66 million; *Itel*—$40 million; *Equity Funding*—$60 million; *Oak Industries*—$32 million; *Nucorp Energy*—$60 million; *LILCO*—$50 million; *Ames Department Stores*—$42 million; *U.S. National Bank*—$27 million; *Baldwin-United*—$183 million; *Walt Disney*—$45 million; *Network Equipment*—$21 million; *Genentech*—$29 million; *Software Toolworks*—$26.5 million; *Warner Communications*—$18 million; *Pepsico*—$18 million—and there are many more.

Id. at 271–272.

[63] See Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497 (1991).

[64] In an extreme articulation of this argument, the president of the Securities Industry Association asserted: "Plaintiffs' lawyers and the professional plaintiffs are burying corporate issuers, underwriters, broker-dealers, accountants, and others in litigation that does little to discourage wrongdoing, but does much to line the pockets of the plaintiff's lawyers." Private Litigation under the Federal Securities Laws, supra n.15, at 316 (statement of Marc E. Lackritz).

The Chairman of the AICPA urged that the "securities litigation system . . . prevents defrauded investors from recovering anything but a few cents on the dollar." Id. at 300 (Statement of Jake L. Netterville). Or as a New York Times headline more succinctly stated in the headline to an article critical of plaintiffs securities attorneys: "Millions for Us, Pennies For You," N.Y. Times, Dec. 19, 1993, § 3 of 1. Cf. Bowers & Gupta, Shareholder Suits Beset More Small Companies, Wall St. J., Mar. 9, 1994, at ——.

The Senate Securities Subcommittee Hearings on Private Litigation under the Federal Securities Laws were enlivened by the testimony of a disgruntled shareholder who complained that in two lawsuits she received small percentages of her losses (17 percent in one instance; 4–5 percent in the second), while attorneys received $3.3 million of a $9.1 million recovery in the first suit (36 percent) and $7.8 million of $30 million in the latter (26 percent)—Private Litigation under the Federal Securities Laws, supra n.15, at 44–45 (statement of Patricia Reilly).

Senator Domenici estimated that between 30 to 50 percent of settlement funds goes to lawyers' fees. Id. at 6. See also id. at 18 (statement of Richard J. Egan: "Companies will pay enormous sums to law firms and not their investors").

[65] See, e.g., id. at 52 (statement of Senator Dodd); id. at 344 (statement of Senator Domenici); Cong. Rep. S.3695 (statement of Senator Dodd) (Mar. 24, 1994); S.3706 (statement of Senator Domenici) ("there are no clients").

[66] Coffee, The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation, 48 Law & Contemp. Probs. 5 (Summer 1985); Coffee, Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law through Class and Derivative Actions, 86 Colum. L. Rev. 669 (1986); Macey & Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1 (1991); Winter, Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 Duke L.J. 945, 948–953 (1993); cf. Snyder & Gonick, The Interrelationship of Securities Class Action Litigation and Pension Plan Tax Policy: What's Really at Stake?, 21 Sec. Reg. L.J. 123 (1993); Note, 10b–5 or Not 10b–5: Are the Current Efforts to Reform Securities Litigation Misguided?, 61, Fordham L. Rev. S.351 (1993).

As Professors Jonathan Nacey and Geoffrey Miller generalized:

> The traditional image of the lawyer is of an independent professional providing advice and advocacy on behalf of a client. The attorney, in this view, is an agent of the client and subject to the client's control in all important matters. Plaintiffs' class action and derivative attorneys do not fit this mold. They are subject to only minimal monitoring by their ostensible "clients," who are either dispersed and disorganized (in the case of class action litigation) or under the control of hostile forces (in the case of derivative litigation). Accordingly, plaintiffs' class and derivative attorneys function essentially as entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit.

58 U. Chi. L. Rev. at 3.

The concern is that plaintiffs' attorneys will be "unfaithful champions" of the actual plaintiffs, making litigation decisions to a greater extent than is generally the case based on the attorneys' own self-interest rather than that of the client. This conflict could potentially influence several fundamental aspects of litigation including whether to initiate a lawsuit, whether to settle, and the size of the attorney's fee.

(1) Dr. Vincent O'Brien, after a study of 533 securities class actions in the 5-year period, 1988–1993, reported that the cash amount of settlement was 6 percent of total trading losses for purchasers of common stock during the relevant period. It is important to bear in mind that the 6 percent figure was generated by a random sample of only 20 cases.[67]

A fundamental difficulty with the O'Brien study is its confusion of investor losses with recoverable damages. Section 28(a) of the Securities Exchange Act limits recoveries to "actual damages" which normally is calculated to mean tort or out-of-pocket damages. As a practical matter, a plaintiff might recover the initial purchase price minus the sales or stock price after corrective disclosure minus market movements and minus other negative factors not proximately caused by the defendants. For example, if a plaintiff bought stock at $50 and sold immediately after corrective disclosure at $30 during a period when an appropriate stock market index had declined 20 percent, and the corporation in question had received negative news unrelated to the alleged securities fraud which could be quantified at $5 per share, damages would not equal $50 minus $30 or $20 as O'Brien suggests, but rather $50 minus $30 minus $10 (20 percent market movement) minus $5 (unrelated bad news) or a total of $5.[68]

Even use of the $5 figure as a baseline for what damages a plaintiff should recover, however, would be too high. The appropriate settlement value of a lawsuit has also to discount for the probability of winning the case at trial.[69] For example, if the probability of a plaintiff winning at trial was 50 percent, the settlement value of the case should be $2.50.

O'Brien's study, in essence, suffers from two flaws: (1) He did not use actual damages under the Federal securities law in his calculation of plaintiff's recoverable damages; and (2) He made no effort to calculate the probability of recovery. He is not unique in the latter deficiency. No large survey of which I am aware has been able to effectively predict litigation outcomes with scientific precision. While I have some sympathy for the difficulty of his task, I must emphasize that these two deficiencies significantly undercut the reliability of his study.

(2) Two similar studies by the National Economic Research Associates suffer from similar methodological problems.[70] In the 1992 NERA study, it was reported that "the average settlement in securities class action suits has increased dramatically. From July 1991 to June 1992, the average settlement was $10.6 million [compared to $5.8 million between April 1988 to June 1991].[71] The percentage of cases dismissed had also increased significantly [albeit only to 8 percent].[72] The plaintiff's bar had recovered about 31 percent of settlements over the 1991 to 1992 period.[73]

Unfortunately, however, the initial NERA study was incapable of estimating actual potential damages and employed what it acknowledged to be a "highly biased"[74] surrogate, a comparison of investor losses discounted by the Standard & Poor's 500 index. The 1992 study concluded: "On any given settlement, investors and plaintiffs' attorneys recovered approximately 8 percent of the investor losses."[75]

In 1993, these data were updated, with the NERA study acknowledging that its investor loss figure had been criticized as bearing "little relation to plaintiffs' damages estimates."[76]

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[67] See summary of his study, O'Brien & Hodges, A Study of Class Action Securities Fraud Cases 1988–1993, supra n.15, at 46–48; 138–141.

[68] See discussion of damages calculations in 9 L. Loss & J. Seligman, Securities Regulation 4408–4427 (1992).

[69] See, e.g., discussion of settlement value in *Joy* v. *North*, 692 F.2d 880, 892 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051.

[70] Dunbar, Recent Trends in Securities Class Action Suits (1992); Dunbar & Juneja, Recent Trends II: What Explains Settlements in Shareholder Class Actions? (Oct. 1993), *reprinted in* Private Litigation under the Federal Securities Laws, supra n.15, at 739–775.

[71] Dunbar, supra n.70, at 1.

[72] Ibid.

[73] Ibid.

[74] Id. at 3 n.10.

[75] Id. at 4.

[76] Dunbar & Juneja, supra n.70, at 743–744:

There has been some commentary that investor losses bear little relation to plaintiffs' damage estimates. One such claim asserts that plaintiffs' damage estimates are about 27 percent of investor losses. [Citing Beverly C. Moore, Jr., "In Camera," *Class Action Reports*, Vol. 16, No. 2, March-April 1993, at 250.] However, the 27 percent figure is obtained by dividing the sum of plaintiffs' damages from several cases by the sum of investor, losses for those cases. This number can be strongly affected if the ratio of damage estimate to loss is low in one case. Using Moore's sample, the average ratio of plaintiffs' damage estimate to investor loss is 59 percent. For a sample of 22 cases for which we had data on both numbers, the average ratio is 78 per-

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Somewhat indecisively, the 1993 NERA study concluded:

[N]o factor on which we have data, other than investor losses, plaintiffs' damage estimate, and number of insurable co-defendants, has consistent, statistically significant impacts on settlement size. . . .

The statutory reform debate should be addressing whether the least meritorious shareholder class actions have benefits that exceed their costs. If not, then too many legal and other resources are being used in this area of litigation and some should be redeployed to lawsuits with more merit. Some policy action would then be appropriate in discouraging marginal lawsuits.

Although debate on shareholder litigation has become heated, relatively little is known about expected costs and benefits of the marginal lawsuit. All of the anticipated benefits from this type of litigation come from the incentives it gives to management—making it more accountable to stockholders and improving the quality and quantity of corporate disclosure. Management accountability to ownership increases overall economic efficiency. The benefits of accurate and timely corporate information should include the following: (1) aiding capital formation by reducing information uncertainty when new securities are issued; (2) reducing the cost of research by analysts and investors because management is presumably the low-cost provider of information; and (3) allowing better monitoring of management by stockholders so they know when to take corrective action. Unfortunately, there is very little empirical research on the role of securities class actions in providing these benefits.

Clearly, when the settlement in a lawsuit reflects neither the probability of liability nor the amount of damages, these benefits are not obtained. Good management behavior is not being rewarded because all management behavior, whether innocent or insidious, is likely to be penalized equally.

Without overstating our statistical findings, if one had to choose among the most important of three factors in explaining settlements—stock price volatility, availability of assets and merits of the case—it would appear that the merits matter the least. This is not to say that the merits do not matter at all. Our statistical results, though very good when judged by the standard of how well analysts usually explain disaggregate data, leave almost 60 percent of the dispersion in settlements unexplained. Some of this unexplained variation may be due to factors reflecting the merits about which we have no data. Also, because investor losses may be correlated with either availability of assets or actual damages, some of the explanation of settlement size may depend upon potential damage exposure which in turn may be reflecting the merits of a case.[77]

In sum, the NERA study did not conclude that the merits do not matter in Federal securities litigation so much as it concluded that limits on empirical research in this area made it difficult to reach unambiguous conclusions.

(3) The third study relied on by proponents of restrictive legislation is by Stanford Law School Associate Professor Janet Cooper Alexander.[78] While Professor Alexander's analysis in many respects is the most sophisticated of the studies I reviewed, her data are not. In essence, she studied nine settlements of computer and computer-related initial public offerings initiated in the first half of 1983. She found that six of the nine lawsuits settled between 20.60 percent and 27.35 percent of "amount at stake." This she defines as: "the difference between the price paid for each share and its price after the bad news is disclosed, multiplied by the total number of shares sold in the offering."[79] Quite aside from the fact that her sample of nine cases is so small as to verge on statistical insignificance, her computation of "amounts of stake" ignores market effects and the impact of other bad news on the damages that a plaintiff can reasonably be expected to recover. She rationalized ignoring these type of data with the following assertion: "Taking account of these [type of] factors would require determinations about the merits, and would thereby introduce the possibility of disagreement about the amount at stake."[80] For me, this is too glib. Unless you begin with an accurate estimation of recoverable damages, how can you intimate that "the merits do not matter"?

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cent. The total plaintiffs' damage estimates over total investor losses for our sample of 22 cases is 57 percent. All three ratios are much higher than 27 percent. In any case, investor loss is not meant to duplicate plaintiffs' damages estimates. But settlement values appear to increase, albeit less than proportionately, with plaintiffs' damage estimates just as they appear to do with investor losses.

[77] Id. at 747–748.

[78] Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497 (1991).

[79] Id. at 515.

[80] Id. at 515–516.

The opponents of new legislation fare no better in terms of the technical quality of their survey results:

(4) A study by a leading plaintiffs' expert witness economics consultant began with the premise that recoverable damages were equal to 27.7 percent of investor market losses and accordingly concluded that in 20 cases in which it served as an expert returns through settlements were equal to 59.78 percent of recoverable damages.[81]

The difficulty with this computation is that it is unclear what, if any, validity should be accorded the 27.7 percent estimation. The percent of investor losses that can be recovered as damages will vary from case to case. There are no talismanic numbers here; simply the caution that survey results of the types offered both by proponents and opponents of new legislature restrictions on Federal securities class actions are unlikely to accurately compute whether plaintiffs are appropriately compensated in settlements because these studies uniformly fail (1) to demonstrate a persuasive methodology by which the percent of potentially recoverable damages has been estimated; or (2) to show how they estimated the probable outcome of litigation.

Does this mean that there are no relevant empirical data to take into account? Quite the contrary, the available data suggest that:

(1) As much as 40 percent of Rule 10b–5 claims in 1992 were dismissed by courts on a motion by defendants. This strongly suggests that nonmeritorious suits generally do not survive until settlement.[82]

(2) Average recoveries in Federal securities class settlements in 1991 and 1993 were approximately $7 to $10 million.[83]

(3) The average attorneys' fees according to NERA were equal to 28 percent of 1991–1992 settlements and 29 percent of 1992–1993 settlements.[84]

These data are not consistent with arguments that "the merits do not matter" or that the Federal securities class action is primarily a vehicle for enriching lawyers.

Conclusion

I strongly urge you to support limited legislation to reverse the Supreme Court's *Central Bank* decision and reestablish the authority under § 10(b) and Rule 10b–5 for the SEC and private litigants to bring appropriate actions against persons who aid and abet securities fraud. I believe such legislation is essential to maintain the integrity of the Federal securities laws' mandatory disclosure system.

With the limited exceptions described above,[85] I do not believe new legislation is necessary in this area.

Sincerely,

Joel Seligman
Professor

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[81] Private Litigation under the Federal Securities Laws, supra n.15, at 150–153.

Two other studies by the two largest class action claims administrators were offered that did not attempt to estimate what percentage of market losses were recoverable damages, but simply compared total recoveries to total market losses. These data are summarized in id. at 272:

Claims Administrator	Cases	Total Claims	Total Recoveries	Total Market Losses	% of Market Loss Recovered
Heffler & Co.	69	271,615	386,000,000	2,800,000,000	13.5
Gilardi & Co.	104	694,111	2,200,000,000	7,700,000,000	29.0
TOTALS	173	965,726	2,586,000,000	10,500,000,000	24.6

See also id. at 172–182 (Heffler & Co. data); id. at 783–792 (Gilardi & Co. data).

[82] See data supra at 5, 18–19.

[83] See NERA data in Private Litigation under the Federal Securities Laws, supra n.15, at 740. In July 1991 to June 1992, average settlements amounts were $10.33 million; in July 1992 to June 1993, average settlement amounts were $7.36 million. See also supra at 6 (calculating average 1992 settlement against Big Six accounting firms to be approximately $10 million).

[84] Ibid. *Class Action Reports* calculated that attorneys fees and cash were equal to 15.2 percent in 334 settlements between 1973 and 1990. Id. at 154.

[85] See supra at 7–8 n.24.

PRIVATE SECURITIES LITIGATION

STAFF REPORT
PREPARED AT THE DIRECTION OF
SENATOR CHRISTOPHER J. DODD
CHAIRMAN, SUBCOMMITTEE ON SECURITIES
OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

MAY 17, 1994

United States Senate

WASHINGTON, DC 20510

UNITED STATES SENATE, COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES

Washington, May 17, 1994

Dear Colleague:

Last summer, the Subcommittee held two lengthy hearings concerning possible abuses of private securities litigation. During and since that time, the Subcommittee received testimony from some two dozen witnesses and thousands of pages of submissions. The Subcommittee staff has carefully studied and analyzed this voluminous material, resulting in this report.

Private lawsuits are critical to ensuring the integrity of the capital markets because, together with government enforcement actions, they are intended to help deter future wrongdoing. When the system is working well, it helps to ensure that corporate officers are honest, and that auditors, directors, lawyers and others properly perform their jobs. Private litigation also ought to ensure that defrauded investors can recover their losses without having to rely on government action. By performing these functions, private lawsuits should promote investor confidence and capital formation. The success of the American securities markets is due to the fact that investors here and abroad trust our markets to be fundamentally fair. That trust stems in part from the Securities and Exchange Commission's role and in part from defrauded investors' ability to take direct action.

In spite of this success, the Subcommittee has heard growing complaints about serious problems undermining the effectiveness of private securities litigation. For example, we have heard concerns voiced about frivolous litigation affecting companies and their auditors, as well as other participants in the securities markets who frequently are joined as defendants in securities fraud lawsuits. In addition, private class action litigation under the federal securities laws has been criticized for failing to provide adequate recoveries for defrauded investors, and in many instances for purportedly benefitting plaintiffs' attorneys rather than their clients. For example, there is a concern that too many plaintiffs' attorneys rank their clients' interests behind the desire for a generous fee award.

Private liability for wrongdoing is important to guaranteeing diligence from those with responsibilities for ensuring that accurate financial information reaches the markets. However, some have suggested that the net effect of private litigation under the federal securities laws has been to weaken the financial disclosure system on which our capital markets depend. The accounting profession, which is at the heart of the financial disclosure system, has warned that because of the doctrine of joint and several liability, accountants face potential liability that could destroy the ability of independent auditors to review financial disclosure by companies. At the same time, a number of observers have called attention to audit failures and other serious problems with the audit function, problems that the current liability system may not adequately address.

These concerns deserve to be closely examined by anyone who believes, as I do, that private lawsuits are too important to maintaining the integrity of our capital markets to permit complacency about these issues. We cannot allow private actions to be misused for purposes other than deterring wrongdoing and compensating defrauded investors.

The views about securities litigation expressed by a wide range of investors, corporate executives, accountants, attorneys and others are evaluated in the report in light of the evidence presented to the Subcommittee. It is my hope that the report will serve as a useful compilation of the evidence and significant policy issues surrounding the effectiveness and consequences of private securities litigation, and will be helpful during future debate about these important issues by the Committee and the Congress.

The report was written by the Majority Staff of the Subcommittee at my direction. The report does not necessarily reflect the views of any of the Members, either majority or minority, although my colleagues have been very supportive of the Subcommittee's efforts in this area. I want to give special thanks to George R. Kramer, Special Counsel to the Subcommittee, who bore the major task of drafting the report, with assistance from Courtney Ward, and with additional help from Sheila Duffy. I also want to thank George Richards, a legal intern with the Subcommittee, as well as Brian Benczkowski, Daniel Ball and Charles Visconte, interns from Senator Domenici's office, who assisted under the direction of Denise Ramonas. I am very grateful for comments and review provided by outside readers, Professor John C. Coffee Jr. of Columbia Law School, Kevin Winch and Michael Seitzinger of the Congressional Research Service, and staff members of the Securities and Exchange Commission. Of course the report does not necessarily reflect the views of any of these readers.

Again, thank you for your support and cooperation with the Subcommittee's efforts on this and many other important topics.

With best wishes.

Sincerely,

Chris Dodd

Christopher J. Dodd
Chairman, Securities
Subcommittee

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INTRODUCTION

This report examines the effectiveness of private securities litigation in meeting the objectives of the federal securities laws. The fundamental purpose of the federal securities laws is to promote investor confidence and thereby encourage investments necessary for capital formation, economic growth and job creation. To achieve such confidence, investors must believe that the markets are fair, and that when they invest in a company's securities, they have all the relevant facts. The federal securities laws are not designed to ensure that investments will be risk-free, but rather to ensure that investors will be informed of all known material risks.

Vigorous enforcement of the federal securities laws by the Securities and Exchange Commission (Commission or SEC) is an essential part of the investor protection system. In addition, Congress, the courts and the Commission have long supported private investor lawsuits as a way to help investors to recover losses caused by legal violations. These private suits are a critical component of the overall scheme of law enforcement, because, like Commission enforcement actions, they can help to deter future violations. Ideally, private investor lawsuits and government enforcement actions should promote both investor confidence and capital formation by helping to keep corporate officers honest, and ensuring that auditors, directors, lawyers, securities professionals and others do their jobs.

The Subcommittee undertook this inquiry into the quantity and quality of private securities litigation because of growing complaints about how a litigation explosion was affecting high technology and other corporations, as well as auditors, outside directors and other professionals who frequently are joined as defendants in securities fraud lawsuits. In addition to these complaints, private class action litigation under the federal securities laws has also been criticized for failing to provide adequate recoveries for defrauded investors, and for benefiting some attorneys rather than their clients. Finally, some have charged that the net effect of private litigation under the federal securities laws has been to undermine the basic full-disclosure philosophy of federal securities regulation because litigation exposure discourages companies from voluntarily disclosing material financial information.

The Subcommittee held two hearings to consider these issues, heard testimony from 24 witnesses, and received thousands of pages of submissions

from many other interested parties.[1] The hearings addressed the following key issues:

- How well does private litigation complement the enforcement efforts of the SEC in deterring securities law violations? Are there abuses in the conduct of private securities litigation? Are frivolous cases filed, and if so, are procedural rules adequate to screen out such cases? How legitimate are concerns that abuses of private securities litigation might have a chilling effect on voluntary financial disclosure?

- Do private securities cases serve the investors on whose behalf they are brought? Do attorneys for members of securities class action litigation adequately represent the interests of their clients? How effective is private securities litigation in recovering damages for defrauded investors?

- How well are independent auditors upholding their role as "public watchdogs" of financial disclosure? Are auditors being unfairly singled out in private securities litigation? Is private securities litigation hurting the future effectiveness of independent auditors, and if so are there other approaches that might lead to better auditing and improved protection against fraud?

- If private actions are not being used effectively to deter fraud, are there other steps that should be taken to enhance fraud deterrence? For example, should Congress enact proposed legislation to extend the statute of limitations for fraud? Should it require auditors to report illegal acts and to take other steps to ensure the integrity of management internal controls?

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[1] Written and oral testimony, as well as a number of other written submissions made to the Subcommittee, are included in the published hearing record, <u>Private Litigation Under the Federal Securities Laws: Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs</u>, 103d Cong., 1st Sess. S. Hrg. No. 103-431 (1993) (hereafter, "Hearing Record"). Because of the volume of material submitted, much of the information received by the Subcommittee and cited in this Report could not be published. That material will remain on file with the Subcommittee staff for the remainder of the year.

BACKGROUND

A. The Disclosure Objectives of the Securities Laws.

The federal securities laws provide a comprehensive legal framework designed to protect investors in the securities markets. The central principle underlying these laws is that investors should receive accurate and timely disclosure of the financial condition of publicly traded companies. Companies offering stock to the public are required to file a registration statement with the SEC and furnish a prospectus to investors containing a complete and accurate description of the company's business, together with audited financial statements. Each public company is required to publish an annual report presenting a discussion of business developments, as well as current audited financial statements. Companies also are required to file quarterly reports and make public disclosure of significant events. A company's independent auditors, its outside directors, and its underwriters play a crucial role in ensuring the accuracy of disclosure and financial reporting.

It should be noted that, in addition to protecting investors, the requirement for full and complete disclosure serves a broader purpose. It is believed that the markets, as a whole, are more efficient when companies' securities trade on the basis of accurate information. Moreover, full disclosure promotes investor confidence in the markets and, thus, encourages the continued investments necessary for capital formation and economic growth.

B. Enforcement Actions Brought by the SEC.

Within this framework, the antifraud provisions of the securities laws and SEC rules prohibit the use of material false and misleading statements or omissions in connection with purchases and sales of securities. These provisions are enforced primarily by the SEC. In appropriate cases, the SEC refers matters to the Department of Justice for criminal prosecution.

For most of its 60-year history, the SEC has enforced the securities laws primarily through civil injunctive actions. In many cases, the SEC has requested, and courts have ordered, that violators disgorge illegal gains to be set aside for injured investors. In 1984, Congress gave the SEC additional authority to seek in federal court civil money penalties in amounts up to three

times the profit gained or loss avoided by persons involved in insider trading.[2] The SEC's enforcement powers were broadly expanded in legislation developed in this Committee and passed by Congress in 1990, which gave the SEC authority to seek fines in both civil actions and administrative proceedings related to a wide variety of securities law violations.[3]

C. Private Actions Brought by Investors.

In addition to the SEC, investors may sue to recover damages they incur as a result of the actions of corporations and other firms and individuals who violate the federal securities laws. These private lawsuits serve a dual purpose. First, they provide a means for investors to obtain recovery for damages caused by fraudulent activity. Second, they serve as an important adjunct to the SEC's enforcement efforts to prosecute those who violate the securities laws and to deter future violations. Actions under Section 10(b) and Rule 10b-5 -- the broad general antifraud provisions of the securities laws -- have become the primary vehicle for recovery by defrauded investors.[4] In

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[2] The Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264. Congress supplemented this law by enacting the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, which imposed specific responsibilities on broker-dealers, investment advisers and securities firms to take steps to detect and deter illegal insider trading activity and imposed substantial money penalties on "controlling" persons.

[3] The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. Among other things, this Act gave the SEC the authority to impose fines of up to $500,000 per violation for serious acts of fraud.

[4] These provisions make it unlawful to use material false and misleading statements or omissions in connection with purchases or sales of securities. Although certain other provisions of the securities laws expressly give investors the right to sue those who violate the law, Section 10(b) does not. However, Federal courts have long held that there is an implied private right of action for investors under Section 10(b). See, e.g. Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 13 n.9 (1971); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 185 (1976); Basic v. Levinson, 415 U.S. 224, 231 (1988); Musick, Peeler & Garrett v. Employers Insurance of Wausau, 61 U.S.L.W. 4520, 4522 (June 1, 1993). The Chief Justice of the United States has described the implied right of action under Section 10(b) as "a judicial oak which has grown from little more than a legislative acorn." Blue Chip Stamps, 421 U.S. at 737 (1975). "As the law has developed, Rule 10b-5 is vastly more important in combatting fraud than are the express remedies provided in the 1933 and 1934 Acts.... Section 10(b) and Rule 10b-5 have come to embrace a diversity of claims which could not have been envisioned in 1934." Brief of the Securities and Exchange

order to establish liability under Section 10(b), plaintiffs must prove a number of elements, including that:

- the plaintiff purchased or sold the securities in question;
- the defendants engaged in a fraud, manipulation or deception;
- the fraud, manipulation or deception was in connection with the purchase or sale of securities;
- the defendant acted with scienter (e.g., an intent to deceive or a reckless disregard for the truth or falsity of a statement);
- the defendant's misstatement was material;
- the plaintiff reasonably relied on the defendant's misstatement;
- the plaintiff was damaged; and
- the defendant's conduct caused the plaintiff's damages.

Until recently, investors could sue both the corporation, firm or individual who directly perpetrated the fraud as well as others who through their relationship with the primary violator "aided and abetted" or "controlled" the person who committed fraud. Aiding and abetting liability has often been used, for example, to pursue outside accountants and lawyers in connection with frauds committed by their clients where the auditor or lawyer recklessly or intentionally failed to detect or prevent the fraud. However, on April 20, 1994 the Supreme Court ruled, in a 5-4 decision, that aiding and abetting liability is not permitted for private anti-fraud actions under Section 10(b) of the Exchange Act.[5]

Commission as Amicus Curiae at p. 23, Lampf v. Gilbertson, 90-333 (June 20, 1991).

[5] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 62 U.S.L.W. 4230, 1994 U.S. LEXIS 3120 (April 19, 1994). The Court's decision, while only addressing the availability of aiding and abetting liability in private 10(b) actions, may also raise questions about (i) whether aiding and abetting liability is available to the SEC in its enforcement actions; (ii) whether other forms of secondary liability may be available in private or SEC actions.

Private actions under the securities laws are often brought as class action suits under the anti-fraud provisions of the securities laws. These cases are generally brought on behalf of large groups of investors who traded in the securities in question during a time period when alleged misstatements or nondisclosure of important facts artificially increased or decreased market prices. Class members are often individual investors who are unsophisticated about securities litigation and have a relatively small economic stake in the litigation, although their collective economic interest could be very large. The defendants in these cases usually include the company that issued the securities involved. In addition, officers, directors, auditors, underwriters and advisers of the company are often included as separate defendants.[6]

D. Summary of Criticisms of Private Securities Litigation.

In recent years, there has been growing criticism of the current system of private securities litigation. Critics have said that too many cases are pursued for the purpose of extracting settlements from corporations and other parties, without regard to the merits of a case, and that the settlements yield large fees for plaintiffs' lawyers but compensate investors for only a fraction of their actual losses. Moreover, they argue that frivolous litigation is time-consuming and distracts chief executives and other corporate officials from productive economic activity. They also argue that securities litigation seeks huge monetary recoveries from outside directors, outside lawyers and independent accountants, who may be only marginally involved in activity for which corporate officers should be primarily liable. Finally, they suggest that private lawsuits for securities fraud may have a chilling effect on corporate disclosure.

Courts have expressed concern as well. For example, the Supreme Court has said:

For a detailed discussion of issues pertaining to aiding and abetting and other forms of secondary liability under the federal securities laws, see Kuehnle, Secondary Liability Under the Federal Securities Laws -- Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme, 14 J. Corp. L. 313 (1988).

[6] The defendants' insurance carrier is another unnamed, but very interested, party in class action securities litigation. Depending on the type of culpability alleged and proven against defendants, their liability carriers may be the most likely source of recovery.

"[I]n the field of federal securities laws governing disclosure of information, even a complaint which by objective standards may have very little success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment. The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit."[7]

The current litigation system also has been criticized by some academics, who contend that corporate defendants who are sued after a stock price decline have strong incentives to settle, whether or not they have done anything wrong. For example, as discussed at page 33 below and in Appendix A, studies by Professor Janet Cooper Alexander and others contend that most securities class actions are settled by the parties, without regard to whether the case has merit. As discussed at pages 75-79, observers such as Professor John Coffee have concluded that plaintiffs' attorneys in many securities class actions appeared to "sell out their clients in return for an overly generous fee award," and that defendants may also join in this collusion by passing on the cost of the settlement to absent parties, such as insurers.

Critics suggest that a number of factors other than actual fraud might be driving the litigation and settlement process. For example, insurance coverage generally excludes judgments for fraud. Therefore, critics suggest, plaintiffs and defendants both have an incentive to reach a settlement in which the defendant agrees to a judgment not based on fraud. Moreover, many likely defendants in securities litigation are highly risk averse. For example, there are reports that independent directors opt for settlement rather than face a potential financial exposure vastly in excess of the fees and other compensation they receive from the company. Critics also argue that the dynamics of the litigation process itself give securities plaintiffs economic leverage to produce a settlement. They assert that pre-trial discovery in complex securities cases is likely to be much more expensive and burdensome for defendants than it is for plaintiffs. At the same time, courts are often reluctant to grant defendants' motions to dismiss or for summary judgment, because securities fraud allegations normally turn on complex mixed issues of law and fact that are difficult to dispose of on a pretrial motion.

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[7] Blue Chip Stamps v. Manor Drug Store, 421 U.S. 723, 740 (1975).
The Court made this statement in the course of limiting the applicability of antifraud claims to only those who actually purchased or sold securities.

E. Relationship Between Private Litigation and Financial Reporting.

One benefit of private securities litigation should be to help ensure the integrity of the financial disclosure system by encouraging all parties involved in the disclosure process -- accountants, outside directors, underwriters -- to act with honesty and diligence. However, some critics suggest that private litigation might actually inhibit voluntary disclosure by corporations, discouraging them from making any public statements except when absolutely required, for fear that anything they say that might effect the company's stock price might also guarantee a law suit.

Critics also say litigation drives away accountants and potential independent directors and other outsiders from involvement with newer publicly traded companies, or companies in industries that are susceptible to volatile stock prices, because of concern for their litigation exposure. Accountants, in particular, argue that a liability crisis is affecting the very viability of some firms to continue practicing. Because of the concept of joint and several liability, accountants argue that they are liable for a disproportionate share of damages compared to their actual level of responsibility.[8]

Concerns about the impact of litigation on the availability of outside auditors to new companies is especially significant because of the central role outside auditors play in the financial disclosure process. At the time when the proposed federal securities laws were being considered by Congress, the suggestion was made that government regulators should directly oversee the preparation of financial statements that were to be distributed to public investors. The accounting profession opposed this idea, and argued that it could audit the financial statements of securities issuers more efficiently and effectively than the government. The proposal of the accounting profession prevailed, and the securities laws as enacted gave accountants a new franchise and new responsibilities by mandating that securities issuers' financial

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[8] Under joint and several liability, an accounting firm that audited the books of a company found to have engaged in a fraud could be held liable for the entire amount of investor losses if the accounting firm itself was reckless in its audit. Accounting firms may seek to recover contribution from the corporation or other wrongdoers for amounts paid in excess of their "fair share" of the liability. However, shareholders may include accounting firms as "deep pocket" defendants in cases where the corporation itself may be bankrupt.

statements be certified by independent accountants. Critics of the accounting profession maintain that private litigation is a necessary means for ensuring that accountants perform their duty to investors, and is therefore essential to encourage diligence by outside auditors in certifying financial statements on which the investing public relies.

F. Importance of Private Litigation.

The American capital markets have maintained their preeminent position in the global economy due primarily to the view widely held by investors worldwide that American markets are generally very honest. Investor confidence in the fairness of American markets is bolstered by a system that permits private lawsuits for securities fraud. Despite the claim by critics that securities litigation is hampering capital formation, initial public offerings have proceeded at a record pace in recent years, and a long list of notorious cases have recovered billions of dollars for defrauded investors.

The SEC has long maintained that private actions are an important adjunct to the SEC's enforcement efforts. Although the SEC plays the principal role in enforcing the federal securities laws, it repeatedly has stated its view that

> "[p]rivate litigation is an essential element in enforcing the rights of more than 50 million Americans who participate in the U.S. securities markets. If, as a practical matter, private actions under the antifraud provisions are frequently barred, then the level of deterrence and compensation could be significantly weakened.... Most fundamentally, of course, deliberate fraud against investors is morally and legally wrong, and there is not any evidence available in light of current market events that existing protections against fraud are too extensive. Weakening safeguards against fraud could make investments more hazardous and less attractive to investors, thereby raising the cost of capital for businesses."[9]

However, the SEC also has expressed concern about frivolous shareholder lawsuits and other possible shortcomings of the current system and has

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[9] Securities Investor Protection Act of 1991: Hearing Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs 102nd Cong., 1st Sess., S. Hrg. 102-410 at 3-4 (October 2, 1991)(Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission) (hereafter "Breeden testimony").

suggested that "[l]egislative reform measures that have the potential to deter meritless private securities fraud cases deserve serious consideration" provided that they are "directly targeted at meritless litigation" without affecting meritorious litigation.[10]

To the extent there are abuses, there are some tools currently available to defendants and the courts with which to address frivolous litigation. For example, provisions of the Federal Rules of Civil Procedure give courts the ability to dismiss cases in which plaintiffs are not able to posit sufficient facts to suggest that fraud has occurred, and permit courts to impose certain sanctions on parties or their attorneys who take positions that are not adequately grounded in fact or in law, or that are interposed for an improper purpose, such as to cause unnecessary delay or needless costs.[11]

Much of the litigation exposure faced by groups such as accountants and independent directors does not stem from the federal securities laws, but from actions under state law, where punitive damages are often available, and legal standards for liability may be lower. According to the six largest accounting firms, only 30 per cent of the private litigation against them involves claims under the federal securities laws.[12] Moreover, a 1991 survey of officer and director insurance policy claims found that claims based on disclosure violations constituted approximately 11 per cent of all claims against corporate officers and directors.[13]

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[10] Prepared statement of William R. McLucas, Hearing Record at 120.

[11] Some of these devices are discussed in greater detail at pages 35-42 below, Rule 9(b) of the Federal Rules of Civil Procedure permits courts to compel plaintiffs to plead allegations of fraud with specificity. In addition, courts are sometimes able to eliminate cases that lack sufficient evidence before trial on motions for summary judgment. Rule 11 of the Federal Rules of Civil Procedure gives court some authority to impose fees and costs for certain litigation abuses, such as filing a case for which the plaintiff has no basis in fact. As discussed at pages 36-40 below, this provision has recently been amended, and its future effectiveness in deterring frivolous litigation and other litigation abuses is unclear. Specific procedures for handling class actions are set out in Rule 23 of the Federal Rules. These procedures require that the court approve the plaintiffs representing the class, review the fairness of any settlement to class members, and approve any award of attorneys' fees to plaintiffs' attorneys from settlement funds.

[12] See infra note 267.

[13] See Wyatt Company, Directors and Officers Liability Survey, 48 (1991).

* * *

In order to assess the effectiveness of the current private litigation system more clearly, this report will examine several issues in light of the policy objectives of the federal securities laws. Part One examines complaints about frivolous litigation under the federal securities laws. Part Two examines the way that class action securities litigation operates, and the extent to which investors' interests are adequately represented. Part Three discusses the impact of the present liability system on the role of the accounting profession, and related questions about the logic and fairness of the existing system of allocating liability. Part Four considers whether the current statute of limitations undermines the purpose of private rights of action by rewarding those who conceal illegal activities for long periods of time, or whether it is an effective answer to the problem of frivolous litigation.

PART ONE -- THE IMPACT OF FRIVOLOUS LITIGATION UNDER THE FEDERAL SECURITIES LAWS

Introduction

The Subcommittee has heard numerous reports that the competitiveness and job-creating ability of U.S. corporations is being impaired by the cost of responding to frivolous securities lawsuits. Critics of private securities litigation contend that the current system of private liability under the federal securities laws does not adequately distinguish between meritorious and frivolous claims. According to these critics, this results in a disproportionate number of private cases, particularly class actions, that are brought without regard for whether the case has merit. Such cases are alleged to be a growing problem for corporations and shareholders alike. The problem is said to be growing, in part, because courts have been unable or unwilling to discipline attorneys for bringing such cases, and in part because the dynamics of the bargaining process in securities litigation are such that many defendants would rather settle than litigate a frivolous claim.

In assessing these concerns, it is important to distinguish between a case that is "frivolous" and one that simply turns out not to have merit. In all areas of civil litigation, plaintiffs file cases which they ultimately lose, either by dismissal or voluntary withdrawal, or by losing at trial. It is inevitable that some part of the time a judge or jury will ultimately disagree with a plaintiff about whether the facts support his right to a judgment, or that a plaintiff will change his mind about the strength of his case as he obtains better information through civil discovery. Cases which are filed which ultimately do not prevail do not necessarily demonstrate any problem with the system of private litigation. If plaintiffs could only bring cases which were virtually certain of success at the time they were filed, very few cases would ever be filed, but investor confidence and deterrence would probably not be well served.

On the other hand, litigation is a blunt instrument, capable of inflicting considerable direct and indirect costs on the parties and the courts. The social costs of litigation include overburdened courts, diversion of private capital from other economic uses to pay lawyers' fees, and the disruption of business productivity through the distraction of civil discovery. These costs are especially high in complex civil litigation, such as securities litigation. ***Therefore, there are compelling public policy reasons to forbid a plaintiff from bringing a case unless he or she reasonably believes it to***

have merit based on the available facts at the time the case is filed The Subcommittee's inquiry is intended to address this type of "frivolous" case, not cases which in hindsight turn out to lack merit.

Illustration of Litigation Abuses An example of the sort of frivolous case that has caused concern in many quarters arose in a recent case filed in the United States District Court for the Eastern District of Pennsylvania. In Greenfield v. U.S. Healthcare, Inc., the U.S. District Court awarded the defendant reasonable costs and attorney's fees pursuant to Rule 11 of the Federal Rules of Civil Procedure, dismissed the actions, and referred the matter to the Disciplinary Board of the Supreme Court of Pennsylvania.

On November 4, 1992 the Wall Street Journal published an article which highlighted sales by U.S. Healthcare, Inc. officers prior to an announcement of an earnings decline.[14] Later that same day a suit was filed on behalf of Robert K. Greenfield. On November 5, 1992 the same law firm filed a suit on behalf of plaintiff Allen Strunk which was a verbatim copy of the Greenfield Complaint. On November 6, 1992 a different law firm filed suit on behalf of Scott and Patricia Garr which once again was an essentially verbatim copy of the first complaint.[15] Each of the complaints alleged violations by U.S. Healthcare and some of its officers and directors of Section 10(b) of the Exchange Act, and each requested certification as class actions on behalf of certain purchasers of U.S. Healthcare stock.

On November 6, 1992, the defendants filed a motion for sanctions, citing violations of Rule 11 of the Federal Rules of Civil Procedure and of the Pennsylvania Rules of Professional Conduct because of the plaintiffs' attorneys alleged failure to conduct a "reasonable inquiry" into the underlying facts and law. On November 8, 1992 Greenfield read the complaint filed on his behalf for the first time. Greenfield became concerned because a relative had an important business relationship with U.S. Healthcare, and he promptly telephoned and wrote to his attorney citing a conflict of interest and a desire to withdraw the complaint. After a delay of two days, the law firm representing Greenfield made a motion to withdraw the complaint on November 10, 1992.

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[14] Peers, U.S. Healthcare Insiders Sold Stock Before Last Week's 17% Price Decline, Wall St. J., Nov. 4, 1992, at C14.

[15] Greenfield v. U.S. Healthcare, Inc., 146 F.R.D. 118, 121 (E.D. Pa. 1992).

On February 4, 1993 the District Court cited the attorneys in all three cases for violations of Rule 11 of the Federal Rules of Civil Procedure, awarded the defendants reasonable costs and attorneys fees, dismissing all three actions with prejudice, and referring the matter to the Disciplinary Board of the Supreme Court of Pennsylvania. In finding that there was sufficient basis to suggest that the conduct of Greenfield's lawyer, Malone, could constitute a violation of Pennsylvania's Rules of Professional Conduct, the court stated:

> "In the rush to be the first to file a class action against U.S. Healthcare, with the probable expectation of being named lead counsel to represent the class and thus obtaining the major share of any fees, Malone put his pecuniary interests above that of his client and compromised his corresponding ethical obligations. The desire to be first got in the way of professional judgment."[16]

The court also held that the Garrs' lawyers, Levin and Sklar, failed to conduct their own reasonable and independent analysis of the facts and law which form the basis of their pleadings and motions. The court found that the Garrs' lawyers relied on the facts published in an article in the Wall Street Journal and alleged in the Greenfield Complaint without conducting any additional inquiry.

> "Although their violations of Rule 11 may be different in kind, Malone, Levin, and Sklar share one common shortcoming in the service they purported to render to their respective clients. In believing that being the first attorney to file a class action against U.S. Healthcare, with the probable expectation of being named lead counsel to represent the class and thus obtain the major share of any fees, was the top priority to be achieved, each attorney pushed into the background the most basic obligation imposed by Rule 11 -- to 'Stop, Think, Investigate and Research' -- before filing a complaint in their client's name."[17]

The court awarded $27,553 in costs and attorney's fees and referred the matter to a state professional disciplinary board.[18]

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[16] Id at 128.

[17] Id

[18] Id. at 129.

In addition to this and other publicly reported cases,[19] the Subcommittee heard from a number of witnesses representing high technology industries, the accounting profession, securities broker-dealers and investors who asserted that they had been harmed by frivolous securities lawsuits. These witnesses contended that too many cases are filed without a reasonable investigation into the facts beforehand and that courts do not effectively screen out groundless cases. Because it is difficult and expensive to get such cases dismissed, their argument runs that parties tend to settle such cases on terms which are unrelated to whether a particular case has merit.

Other witnesses and commentators stated alleged litigation abuses may be exaggerated. These witnesses pointed to statistics showing no significant upsurge in securities litigation. Witnesses emphasized that private securities litigation does meet the fundamental purpose of compensating defrauded investors and deterring fraud. Thus, the Subcommittee was cautioned against taking any steps that might weaken the ability of private rights of action to meet these important policy objectives.

Several questions might help in reaching conclusions about the scale of frivolous securities litigation. Is securities litigation in general increasing or decreasing? How large a portion of all securities cases are frivolous, and are the proportions of such cases in the overall mix of private securities litigation increasing or decreasing? If too many frivolous cases are being filed, are they having an effect on the outcomes of cases -- in other words, is the outcome of securities litigation being determined by factors other than the actual merit of each case? What features distinguish frivolous litigation from legitimate cases? To what extent are current procedural tools being used to screen out frivolous cases? If procedural tools are not screening out many such cases, does that suggest that frivolous cases are not a significant problem, or that the procedural tools are not effective?

A. Evidence Concerning Frivolous Litigation

Part One of this report considers the testimony and other evidence bearing on frivolous litigation. First, it summarizes the testimony presented to the Subcommittee concerning the nature and scope of frivolous securities litigation and the effect of such frivolous litigation on companies, investors and others, as well as on the overall financial disclosure system. Second, it

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[19] See, e.g. Capri Optics Profit Sharing v. Digital Equipment Corp., 950 F.2d 5, 13 (1st Cir. 1991) ("we have never seen such a case of the meretricious posing as the meritorious.")

summarizes academic research on frivolous securities litigation. Third, this section considers the impact of current procedural tools in weeding out frivolous litigation. Fourth, it considers whether securities litigation on the whole has a positive or negative effect on financial disclosure by corporations. Finally, the report considers the possible implications of several proposed solutions to frivolous litigation.

1. **Summary of Testimony**[20]

Several witnesses testified that private securities cases, brought without regard to whether the case had any merit, had adversely affected them. Other witnesses responded that securities litigation is no more prone to abuse than other areas of law, and that most securities litigation is brought in good faith and helps to protect investors from fraud.

Corporate Executives. At the Subcommittee's June 17 hearing, four officers of companies in "high-technology" markets testified on the impact of securities litigation. The widespread nature of their concerns was reflected by the fact that one of the witnesses was testifying on behalf of dozens of companies with combined revenue of $65 billion and total employment of 585,000.[21] These witnesses testified that frivolous securities cases are often filed soon after a drop in a company's stock price. John G. Adler testified that high technology companies are particularly susceptible to such suits because their stock trades at a high multiple of earnings, and therefore responds very dramatically to earnings announcements.[22] Edward R. McCracken also said that companies in markets that depend on a high degree of innovation tend to have more volatile results.[23] According to F. Thomas Dunlap, "a lot of R&D is, by its very nature, speculative. We don't know what technology is going to

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[20] The testimony of two witnesses, Edward J. Radetich and Dr. Vincent E. O'Brien, was based on their empirical research and is discussed together with empirical work by others in Appendix A to this Report.

[21] These witnesses were John G. Adler, the Chairman and Chief Executive Officer of Adaptec, Inc., testifying on behalf of the American Business Conference, Edward J. McCracken, President and Chief Executive Officer of Silicon Graphics, Inc., testifying on behalf of the American Electronics Association and American Entrepreneurs for Economic Growth, Richard J. Egan, Chairman of the Board of EMC Corporation, and F. Thomas Dunlap, Jr., Vice President, General Counsel and Secretary of Intel Corporation.

[22] Prepared statement of John G. Adler, Hearing Record at 103.

[23] Prepared statement of Edward R. McCracken, Hearing Record at 94.

really turn out. When you spend that kind of money, some things are going to work, some things aren't going to work. The result is that, very often, you can have some short-term volatility in high-technology companies."[24] Dunlap noted that Intel Corporation went for 23 years without being sued for securities violations, but has been sued seven times in the last two years, even though its stock price had climbed from 23 1/2 to 56 1/2 between August 1991 and June 17, 1993.[25]

Each of the corporate executives described what they characterized as "strike suits" that were filed against their companies, generally following an adverse earnings announcement and resulting stock price drop. For example, McCracken described a case that was filed against Silicon Graphics, Inc. following an announcement in April 1991 of its first quarterly decline in earnings in seven quarters. The company's stock price dropped 10 per cent following the announcement. The earnings decline, which the company attributed to disruptions in customer orders caused by the Persian Gulf War, was announced two weeks ahead of the company's normal time for releasing quarterly results. A few weeks later, a lawsuit was filed against the company for securities fraud, on the theory that the company knew two months earlier that results would be below expectations, but did not disclose that information. McCracken testified that Silicon Graphics responded by inviting the plaintiffs in to look at documents and interview a senior official, in an effort to persuade them to drop the case voluntarily. The case was not withdrawn, and Silicon Graphics successfully moved to have the case dismissed. However, the case was refiled, with the daughter of the attorney's stockbroker as the named plaintiff. According to McCracken, the plaintiff refused to drop the case unless Silicon Graphics agreed to pay her attorneys' fees. Silicon Graphics decided to accede to this demand rather than pay for the litigation expense of seeking another dismissal.[26]

In another illustration, a case was filed against EMC Corporation twenty hours after it reported that its quarterly profits would decline from the previous quarter. Egan testified that the litigation resulted in substantial litigation expense before it was dismissed by the court "with prejudice." According to the Court, "the plaintiffs apparently wish to embark on a fishing

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[24] Hearing Record at 19.

[25] Id

[26] Id. at 12-13.

expedition at the defendants' expense." However, the court did not impose any sanctions on plaintiffs or their attorneys[27].

These executives described several characteristics of what they view as frivolous litigation. They noted that such cases tend to be filed very quickly. For example, three law suits were filed against Intel Corporation within 48 hours of an adverse earnings announcement[28], and, as noted above, a case was filed against EMC Corporation within twenty hours of an adverse announcement.[29] According to the executives, such cases also tended to have plaintiffs with a proclivity for litigation, or who have some relationship to the plaintiffs' attorney that might give rise to conflicts of interest, or who own very small amounts of stock[30]. However, the only specific example of any of these characteristics was McCracken's description of the suit brought by a family member of the plaintiffs' attorney's stockbroker.

The corporate executives testified that these types of cases often cost millions of dollars to litigate, and, perhaps more important, they divert management from running the business. McCracken testified that the case filed against Silicon Graphics resulted in $500,000 being diverted from research and development to litigation, it distracted to varying degrees approximately 200 employees, and harmed the company's reputation.[31] Dunlap testified that two of the cases brought against Intel were dropped by plaintiffs after Intel's lawyers prepared a letter setting out the facts and threatening to move for Rule 11 sanctions. He said Intel paid $500,000 in attorney's fees just to prepare those letters.[32]

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[27] Prepared statement of Richard J. Egan, Hearing Record at 108-09; Pommerening v. Egan, 141 F.R.D. 370, 373 (D. Mass. 1992).

[28] Prepared statement of F. Thomas Dunlap, Jr., Hearing Record at 110-11.

[29] Egan statement, Hearing Record at 108.

[30] Egan stated that the plaintiffs in the two securities cases filed against his firm owned "only a minimal amount of our stock." Hearing Record at 108.

[31] Hearing Record at 13.

[32] Id. at 20.

The executives also argued that frivolous suits have a chilling effect on corporate disclosure to the financial community[33], make it harder to find qualified people to serve on corporate boards[34], undermine the competitiveness of American companies, and penalize businesses that innovate. For example, Egan testified that as a result of a lawsuit filed against his company following an adverse earnings announcement, the company decided to limit future public disclosure about earnings expectations.[35]

They also noted that many restraints that normally might apply to a plaintiff's lawyer are absent from class action securities litigation. As McCracken observed, "from the point of view of the plaintiff's law firm, why shouldn't the case be filed? You don't have a 'real' client, who controls the case and will temper the attorneys' zeal with the realities of relationships or economics. And the plaintiffs' attorneys aren't worried about expenses, since they get paid by the defendants in the settlement arrangements.... Simply put, accusing companies and individuals of fraud has virtually no downside, and provides a lucrative career for those attorneys who pursue it."[36] F. Thomas Dunlap observed that cases filed merely on a drop in stock price[37] "are tantamount to the 'greenmail' practices that received such wide coverage in the financial press of the 80s, in that many companies don't have the resources to fight the lawsuits, and consequently, may find it less expensive to settle their cases for damages than to defend themselves in court."[38] McCracken and

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[33] The question of whether securities litigation impairs financial disclosure by corporations is discussed at pages 42-45 below.

[34] As described further below, Jean Head Sisco submitted written testimony on behalf of the National Association of Corporate Directors which expanded on this point.

[35] Egan statement, Hearing Record at 108. In subsequent meetings with Subcommittee members and staff, a group of general counsels from high technology companies underscored this point, noting that their disclosure practices have changed substantially in recent years.

[36] McCracken statement, Hearing Record at 94.

[37] Several of the executives asserted in their oral testimony that some plaintiffs' attorneys filed suits whenever a stock price dropped more than 10 per cent, although no evidence was cited to support this assertion. Vincent O'Brien, an economist who has conducted an extensive study of securities class actions, noted that the average price drop for companies that are sued is 51 per cent, although some companies with price drops under 10 per cent were sued. See Appendix A, at 159.

[38] Dunlap statement, Hearing Record at 111.

Dunlap also stated that frivolous securities litigation was a much more serious problem for them than in other areas of litigation, although Dunlap and Adler noted that intellectual property litigation was also a significant expense.[39]

Corporate Directors. Jean Head Sisco submitted written testimony on behalf of the National Association of Corporate Directors which reported that as a result of the threat of frivolous litigation "[m]ore and more companies are finding it virtually impossible to fill their board of directors positions with qualified individuals because these unwarranted securities class action suits expose outside directors to personal liability." She noted that the "inability to attract excellent independent directors is especially damaging to the small, emerging high-tech companies that are disproportionately the target of these lawsuits. These start-up firms are being deprived of essential managerial know-how that comes from the board of directors." She noted that the inability to attract talented outside directors deprives such firms of expertise in marketing and finance that could be invaluable, makes it much more difficult for companies to obtain financing, and can adversely affect the effectiveness and independence of audit committees.[40]

Investors. Ralph Witworth, the President of United Shareholders Association, a nationwide organization with 65,000 members, was critical of private securities litigation, asserting that "meritorious and marginal cases are treated the same because the managers of law-suit factories specializing in these cases are motivated to maximize their share of settlement proceeds in the shortest time possible and move on to the next case."[41]

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[39] Hearing Record at 23.

[40] Prepared statement of Jean Head Sisco, Hearing Record at 644. A survey by Louis Harris and Associates in 1992 revealed that half of all Fortune 1000 outside directors have been sued in connection with their board responsibilities. The survey also revealed that concern about potential litigation exposure or inadequate insurance coverage for such exposure was the most important factor dissuading potential members from joining a corporate board. On the other hand, only one in five outside directors responding to the survey thought that "frivolous and spurious suits" against them was a major concern. See Louis Harris and Associates, Outside Directors and the Risks They Face: A Study Conducted for Executive Risk Management Associates, 3, 6 (1992). On the other hand, as discussed at page 12 above, another survey revealed that only 11 per cent of all litigation against officers and directors was based on disclosure violations.

[41] Prepared statement of Ralph V. Witworth, Hearing Record at 364.

Maryellen Andersen, the Treasurer of the Council of Institutional Investors ("CII"), pointed out that her organization, whose investors have invested over $600 billion on behalf of millions of employees and other beneficiaries, have a very substantial stake in the proper functioning of the private securities system.[42] "As the largest shareholders in most companies, we are the ones who have the most to gain from meritorious securities litigation.... We are also the ones paying the settlements when the lawsuits are frivolous."[43] Andersen stated that CII believed that the litigation system was not working correctly, although"[t]here is still major disagreement about whether there are a huge number or a small number of frivolous securities strike suits filed.... There are also still major disagreements about the size and utility of the legal, administrative, settlement, and lost opportunity costs generated by the present system. But we all know that because of the tremendous number of these cases the costs are very significant."[44]

Accountants.[45] A.A. Sommer, Jr., the head of the Public Oversight Board of the American Institute of Certified Public Accountants, testified that frivolous litigation was a particular problem for accountants:

> "[O]ur oversight of the Quality Control Inquiry Committee of the SEC Practice Section indicates to us that much litigation is brought against accounting firms that is ill-founded, lacking in merit, and often downright frivolous. The Quality Control Inquiry Committee was established to review litigation brought against the auditors of publicly held companies to determine... whether the litigation indicated the possibility of some defect in the firm's quality controls or its compliance with them, or whether there was some deficiency in auditing or accounting standards. Although the focus of the inquiry is so limited, the inquiries often clearly indicate the insubstantial nature of the charges against the auditors. Often auditors are charged with complicity in

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[42] The Subcommittee also received a letter from the State of Wisconsin Investment Board, discussed at pages 71-72 below, which set out a number of proposals for reform of securities class action.

[43] Prepared statement of Maryellen Andersen, Hearing Record at 424.

[44] Id. at 425.

[45] Broader concerns raised by the accounting profession concerning the impact of audit-related litigation on their ability to perform their role in the future are discussed in Section III, at pages 95-119.

management misconduct during times when they were not even retained as auditors. In other cases they are charged with disclosure deficiencies they had nothing whatsoever to do with. And in others they are charged with failing to disclose the declining fortunes of their client notwithstanding that their opinion was qualified with a warning that the company might not be able to continue as a going concern."[46]

Sommer subsequently provided the Subcommittee staff with additional information about frivolous claims against accountants identified by the Quality Control Inquiry Committee ("QCIC").[47] Although the QCIC's review of allegations against accountants is of limited scope,[48] the QCIC found that 71 of the 262 cases (27 per cent) reviewed by it over the past five years involved claims against auditors which were "without foundation on their face."[49] In addition, Sommer reported that in a number of other cases reviewed by the QCIC,

> "even if the allegations involving the accounting firm were all true, the losses claimed by the plaintiffs were caused primarily by economic events or the wrongdoing of others. In a relatively small number of other QCIC cases, the Board has felt, based upon its understanding of the cases, the auditors may have substantially contributed to the damages claimed by the plaintiffs."[50]

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[46] Prepared statement of A.A. Sommer, Jr., Hearing Record at 353.

[47] Sommer advised the Subcommittee staff that, due to the confidentiality policy of the Quality control Inquiry Committee, he could not furnish specific examples of cases that were determined to be frivolous.

[48] "The QCIC's proceedings, conducted in strict confidence, do not seek to determine the merits of a case or the culpability of any party. Rather, their purpose is to review a firm's policies and procedures to assure that, when appropriate, the firm takes measures to upgrade its controls and compliance with them." Letter from A.A. Sommer, Jr. to George Kramer, February 1, 1994, at 1 ("Sommer letter").

[49] Sommer Letter at 1. According to Sommer, the QCIC determined that a case was facially deficient if it contained allegations that (i) suggested a misunderstanding of generally accepted accounting principles, (ii) lacked specific allegations, related to matters unrelated to the auditor's responsibilities, or overlooked disclosures that were included in the financial statements, or (iii) obviously lacked credibility, such as claims against auditors for periods when the auditor did not provide services for the issuer, or for a period when the audit opinion contained a disclaimer. Id. at 2.

[50] Id. at 5.

Plaintiffs' Attorneys. The statements made by corporate officials prompted a rebuttal by William S. Lerach, a noted securities lawyer who frequently represents plaintiffs in securities class actions, and who represents plaintiffs in several of the cases cited by the executives. Lerach strongly disputed the "strike suit" characterization of those cases. Mr. Lerach also argued that the vast majority of private securities litigation is brought following reasonable investigation into the merits of each case.[51] He also suggested that defense counsel was most often responsible for discovery abuses.[52]

When asked about reports that securities class action cases are filed within days or even hours of a stock price drop, Lerach conceded that sometimes cases are filed very quickly. He indicated that one reason was that plaintiffs' lawyers compete very intensely with each other to file first.

> "We are competitive. We want to control the case. We believe we can do the best job and we want to be first to file so that we can control the case, and the case will be competently prosecuted. The courts historically, and maybe this is a problem, the courts historically have rewarded the first filed case with control of the case as lead counsel. That's something the courts have done. We are reacting to that."[53]

Mr. Lerach also disputed the contention by some of the high-technology executives that securities class actions were routinely filed whenever a company's stock dropped by 10 per cent or more. According to Lerach, in each of the cases cited by the executives, while the stock price may have dropped by

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[51] See Prepared statement of William S. Lerach, Hearing Record at 142-43.

[52] "There has been much talk about alleged abuse by plaintiffs' lawyers. But, one often-omitted fact of class action litigation is that the defendants seek to exhaust the plaintiff's counsel by using motion practice and discovery as weapons in a war of attrition. In many cases, defendants' lawyers misuse the process to delay and complicate the litigation." Lerach statement, Hearing Record at 148.

[53] Hearing Record at 80. Lerach added "I don't think there's any question that it makes the executives furious when they're sued the day after a disclosure. I've heard it and I understand it. It's something that ought to be looked at. We talk about it ourselves on our side of the bar. But I still say at the end of the day, the inquiry ought to be, did the case have merit and if it didn't and it was frivolous, then that judge ought to sanction the lawyer who abused the system." Id. at 81.

10 per cent or more, the cases cited were not simply based on a stock price decline, but on other facts, such as sales of stock by insiders prior to adverse announcements, which suggested the possibility of fraud wholly apart from any drop in stock price.[54]

Melvyn Weiss, a law partner of Mr. Lerach, agreed with Lerach that there could be a problem with the current system followed by many courts, of rewarding attorneys for being the first to file a class action by awarding them control over the case.[55] In a response to written questions from Senator Domenici, Mr. Weiss provided additional information which shed light on the extent to which securities litigation is filed soon after major adverse announcements. The information revealed that, over the past three years, out of 229 10b-5 securities suits filed by his firm, 157 were filed within ten days of a major adverse disclosure.[56]

Mr. Weiss also testified that there was no evidence of an "explosion" of securities litigation suits. Weiss noted that audit-related litigation against the six largest accounting firms had declined 30 per cent in the last three years. and he stated that calls for reform by the accounting profession were

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[54] Letter from William S. Lerach to Senator Christopher J. Dodd, July 6, 1993, Hearing Record at 798-99.

[55] Hearing Record at 329.

[56] Mr. Weiss defined "major adverse disclosure" as a disclosure "which takes the investment community by surprise, thereby resulting in a sudden material decline in the trading price of a security." Letter from Melvyn I. Weiss to Senator Donald W. Riegle, October 12, 1993, at 7-8 and Exhibit 1, Hearing Record at 470, 472-502 (hereafter "Weiss letter").

In response to a request from the Subcommittee staff, a coalition of plaintiffs' lawyers surveyed its members to obtain additional data on the extent to which private anti-fraud actions were file quickly after adverse corporate announcements. The survey covered 66 securities class actions which named major accounting firms and which were resolved between July 1, 1990 and June 30, 1993. The survey revealed that 21 per cent of these cases were filed within 48 hours of a public announcement relating to the underlying conduct, and 33 per cent within 10 days of such an announcement. See attachment to letter from Jonathan W. Cuneo, General Counsel of NASCAT, to George R. Kramer, February 16, 1994.

particularly ill-founded.[57] Lerach and Weiss also argued that the Federal Rules of Civil Procedure and Section 11 of the Securities Act of 1933 provide ample safeguards against spurious litigation. Lerach cited several sources that suggested "that in recent years courts have been more willing to dismiss securities fraud lawsuits on the pleadings."[58] Lerach also observed that plaintiffs' lawyers are deterred from bringing frivolous or marginal cases by the contingency fee basis on which they are paid, since they must advance substantial out-of-pocket expenses to prosecute the case, and are not reimbursed if they lose.[59]

The SEC and Other Observers. William R. McLucas, the SEC's Director of Enforcement, testifying on behalf of the agency, said that the evidence of a "litigation explosion" was inconclusive. The SEC noted that statistics maintained by the Administrative Office of the U.S. Courts did not reflect any upsurge in the number of securities litigation cases filed over the past two decades, and only a mild increase in the number of class action securities cases filed. However, the testimony did not analyze certain factors that could be important in evaluating the claims of litigation critics, such as the total amount of damages sought, the number of parties sued, the amounts recovered, or the number of cases dismissed.[60]

While the SEC's testimony did not endorse the view that private securities litigation is on the upswing, the SEC did state its concern about the danger that frivolous litigation can pose for the capital markets. "There is a strong public interest in eliminating frivolous cases because, to the extent that baseless claims are settled solely to avoid the cost of litigation, the system imposes what may be viewed as a tax on capital formation." The SEC noted that "class action counsel tends to operate in an entrepreneurial capacity rather than as a fiduciary operating at the direction of a client. It is likely that plaintiffs will be found, and that cases will continue to be filed, so long as the

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[57] Prepared statement of Melvyn I. Weiss, Hearing Record at 400. This aspect of Mr. Weiss's testimony is discussed in more detail at page 112 below.

[58] Lerach statement, Hearing Record at 143.

[59] Id. at 146.

[60] Information on some of these factors is discussed at pages 29-34 below, and in Appendix A.

prospects of recovery are sufficient to warrant the cost of litigation."[61] The SEC also cautioned that "the issues under consideration are complex, and ... any legislation in this area must be drafted carefully to preserve the benefits of private securities litigation."[62]

Professor Joel Seligman from the University of Michigan Law School testified that in his view there was little reason for significant reform of the federal securities laws, either to benefit plaintiffs or defendants. Professor Seligman pointed out that the total amount of securities offerings reached record levels in 1992, and that more than 50 million Americans own corporate stock. He suggested that an important reason for such success in capital formation and breadth of ownership is the federal securities laws' mandatory disclosure system, together with its system of government enforcement and private litigation. Professor Seligman emphasized that private litigation performs an important role in the mandatory disclosure system, and that less than 10 per cent of cases involving securities or commodities are brought by the government.[63] In a supplemental submission to the Subcommittee, Professor Seligman cautioned that before proposing to add any type of fee-shifting provision to private liability under Section 10(b) of the Exchange Act the Subcommittee should ask itself whether there is an empirical basis to conclude that

> (1) There is a systematic pattern of frivolous litigation that (2) is unaddressed by current fee shifting provisions... (3) but would be addressed by the proposed fee shifting amendment to Section 10(b)?[64]

Professor Seligman rejected the argument that plaintiffs' attorneys, rather than plaintiffs, are the beneficiary of private securities litigation. Seligman suggested that "this critique fails adequately to take into account that the primary purpose of both Governmental and private securities litigation is the deterrence of securities fraud."[65] He also argued that certain proposals

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[61] Prepared statement of William R. McLucas, Hearing Record at 117.

[62] McLucas statement, Hearing Record at 112.

[63] Prepared statement of Professor Joel Seligman, Hearing Record at 131.

[64] See Memorandum from Professor Joel Seligman to George Kramer, August 2, 1993.

[65] Seligman statement, Hearing Record at 131.

for reform. such as curtailing joint and several liability and the "English Rule" of fee shifting were "little more than special pleading by a profession [accountants] which has recently often been successfully sued."[66] As an alternative to those reform proposals, Professor Seligman suggested reducing the "transaction costs of private securities litigation... without jeopardizing the ability of plaintiffs to litigate meritorious claims" through the use of court-appointed "disinterested persons" to oversee the litigation discovery process.[67]

2. **Evaluation of Testimony**

In general, there was little agreement among witnesses seeking relief from frivolous litigation and witnesses who argued that there are few, if any, problems in current securities litigation practices. The information provided by the SEC and others demonstrates that the number of securities cases filed annually, while volatile, appears to be well within historical norms. However, this information does not necessarily answer the charge that much of the litigation is frivolous.

Critics of alleged frivolous litigation, such as the corporate executives, pointed to several features that they thought typified many frivolous cases: cases were often filed as a result of a sudden price decline regardless of whether any facts beyond the price drop suggested wrongdoing; cases tended to be filed days or even hours after an adverse announcement such as an unexpected earnings decline; named plaintiffs in frivolous class action cases sometimes had financial connections to their attorneys that might create conflicts of interest; some named plaintiffs appeared repeatedly in many cases; frivolous cases often involved multiple complaints in which later-filed complaints by ostensibly different parties appeared to copy earlier-filed complaints, sometimes even including identical typographical errors; complaints tended to contain sweeping and vague allegations of fraud, with limited reference to any specific facts; and plaintiff's attorneys tended to make very broad discovery demands for depositions and documents.

Witnesses such as Mr. Lerach, Mr. Weiss and others disputed whether frivolous litigation existed to any significant degree. They also disputed many of the features that were purported to typify frivolous cases and suggested that many of the claims made by critics of securities litigation were based on

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[66] Id.

[67] Id.

hearsay rather than direct evidence. They also suggested that some litigation tactics were not necessarily indicative of frivolous litigation. For example. while Mr. Lerach and Mr. Weiss provided information indicating that many securities cases are filed very soon after an adverse announcement, they suggested that this was because in cases in which multiple complaints are consolidated into one action, courts tend to reward the attorneys who file the first complaint with control over the entire case. They also argued that cases are not filed based only on price declines, but based on evidence suggesting that fraud may have occurred. They pointed out that courts have the ability to dismiss allegations of fraud that are not pleaded with specificity, and they suggested that defense counsel in securities cases are more frequently responsible for dilatory or obstructionist tactics such as overbroad discovery demands.

The perception that insurance coverage is a driving force behind the litigation process was reflected by several of the witnesses at the hearing. One of the high-technology executives, Richard J. Egan, testified that his company, EMC Corporation, hopes to deter securities suits by no longer carrying liability insurance. As he put it, "the first question at a deposition is who are you. And the second question is how much insurance do you have?"[68]

The witnesses who testified before the Subcommittee presented a spectrum of views about the nature of frivolous litigation. Specific cases were cited by witnesses on one panel as exemplifying the problems caused by frivolous litigation, only to have a witness on a different panel strongly dispute whether the cases were in fact frivolous. In order to appraise the contentions of both sides, it is necessary to consider the available empirical research in this area.

3. Summary of Studies of Frivolous Securities Litigation

As the summary of the testimony above demonstrates, discussion of the extent of frivolous litigation is hampered by the subjectivity of deciding which cases are "frivolous". The same problem confronts any attempt empirically to analyze frivolous litigation. Nevertheless, a number of studies have tried several approaches to developing information on securities class action litigation which may reveal something about the nature and extent of frivolous cases.

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[68] Hearing Record at 25.

For example, several studies have tried to compare the amount which plaintiffs have recovered in securities class action settlements with the amount which might have been legally recoverable if they had prevailed in court on their claims. Some have suggested that cases which settle for amounts that are minute compared to potential damages are likely to be weak, while high recoveries may suggest that the system is working properly. Other studies have addressed whether and to what extent securities class action litigation is driven by the merits of each particular case, or by other factors such as insurance coverage or the desire of risk-averse defendants to dispose of cases regardless of their merit. An analysis of recent studies is set out in Appendix A.

Almost every significant study done in this area has been subjected to criticism from some quarter concerning its methodology or the purported biases of its author. Because of difficult analytical or methodological problems (such as trying to distinguish more meritorious cases from less meritorious cases) it may be that no study in this area could be irrefutable. **However, two important observations about securities litigation seem to be supported by the balance of the empirical evidence: cases tend to yield very low recoveries for investors, and cases tend to settle within the amount of insurance coverage available**. Some of the studies also raise serious questions about (i) whether the merits play a significant role in settlement and (ii) whether price declines drive some cases to be filed. However, the evidence is much more mixed on these last two points.

<u>Low Recoveries</u>. Most of the studies suggest that investors recover relatively little of their legally recoverable damages. A study offered by Mr. Lerach suggesting that the recovery rate is around 60 per cent is on the high end of all of the studies, and appears somewhat speculative.[69] All of the other studies indicate that investors typically recover substantially less than half of their recoverable damages, and the O'Brien and Dunbar-Juneja studies suggested recovery rates of well under 10 per cent. Other information provided to the Subcommittee also suggests that typical investor recoveries may be

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[69] For example, the analysis depends entirely on Torkelson's analysis, which like Cooper Alexander's study, may be of limited utility because it is based on a very small pool (20 cases). Additionally, in at least some instances Radetich's and Gilardi's figures might overstate the amount of recovery because they included pre-judgment interest in the amounts recovered by class members.

closer to the figures cited by O'Brien and Dunbar-Juneja than to the figures cited by Lerach.[70]

One methodological obstacle confronting any research in this area is finding a consistent way to measure "legally recoverable damages." Determining the amount of damages which are legally recoverable in any given case is often one of the most contentious issues in a litigation, and often pits expert witnesses against each other, armed with highly sophisticated mathematical models based on various financial or economic theories.[71]

The Dunbar-Juneja study described in Appendix A tried to overcome this problem by adopting a damage estimate often used by plaintiffs in securities

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[70] The State of Wisconsin Investment Board, which administers retirement investment plans for employees of the State of Wisconsin, informed the Subcommittee that a sampling of recoveries in cases in which it was a plaintiff showed that the cases settled for approximately 11 per cent of the total amount of damages sought, while plaintiffs' attorneys received approximately 30 per cent of the recovery amount. See Letter from Kurt N. Schacht, General Counsel of State of Wisconsin Investment Board to Senator Christopher J. Dodd, September 27, 1993, at 1 (hereafter "SWIB letter"). Patricia Reilly, an individual investor who was a plaintiff in two securities class actions, testified to the Subcommittee that she only recovered 17 per cent and 5 per cent of her market losses in the two cases in which she was involved. See Prepared statement of Patricia Reilly, Hearing Record at 134, 136. It is unclear if the market losses in those two cases were comparable to legally recoverable damages. In one case cited by plaintiffs' counsel as an example of the system operating properly, the Subcommittee staff discovered that most plaintiffs recovered 6.51 per cent of their allowed claims. See page 69 below.

[71] The complexity of developing a proper calculation of recoverable damages is illustrated by a recent case in which a court criticized the damage calculation of plaintiff's expert, stating, among other things:

> "In calculating aggregate damages, [plaintiff's expert] used a so-called 'proportional decay' model to estimate the number of shares traded during the Class Period for which the class may recover damages. This model appears to assume that all investors are equally likely to trade, so that a 'proportional' number of shares are assumed to come from shareholders who are long-term holders and from those who are 'in-and-out' traders. Yet a share traded may have a much greater than proportional probability of being re-traded during the Class Period due to the disproportionate influence on trading of short-term traders, arbitrageurs, and similar market participants. Failure to weight the likelihood of trading to reflect the characteristics of trading particular to Oracle would likely result in a serious overestimation of aggregate damages."

In re Oracle Securities Litigation, No. C-90-0931-VRW (N.D. Cal. Aug. 9, 1993) at 13.

class actions.[72] Their study concluded that investors recovered 7 per cent of their recoverable losses on average. However, the authors of this study acknowledge limitations with this approach.[73] An additional limitation on this and other studies is that they do not attempt to quantify the percentage of class members who do not choose to file claims. One observer has pointed out that if, hypothetically, plaintiffs expect that claimants to 40 per cent of the recoverable damages will not be found or will not file claims, plaintiffs would have no incentive to settle for more than 60 per cent of recoverable damages.[74]

It is not clear that low recoveries are necessarily indicative of frivolous cases. As discussed in more detail at pages 75-79 below, to a certain extent low settlement recoveries may reflect a different problem in private securities litigation -- class action counsel who settle cases to maximize their own fees rather than their clients' recovery.[75]

Insurance Coverage. A second observation supported by the balance of the studies is that cases tend to settle within the amount of insurance coverage

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[72] See Frederic C. Dunbar and Vinita M. Juneja, National Economic Research Associates, Recent Trends II: What Explains Settlements in Shareholder Class Actions? (October 1993) (hereafter "Dunbar-Juneja study").

[73] "It should be noted that this approach to damage estimation in 10b-5 and Section 11 securities class action suits can generate highly biased results. It is incapable of determining how much of investor loss is due to the alleged fraud and how much is due to other factors, such as the inherent volatility of the defendant's stock price or idiosyncratic events affecting the firms in the index." Dunbar-Juneja Study at 3, fn. 3.

[74] See Beverly C. Moore, Jr., 14 Class Action Reports No. 5, at 486 (1991). However, this point may lead to circular reasoning, since it may be that many class members, especially small investors, do not file claims because the low amount of recovery does not justify the time and effort of filing a proof of claim form. There does not appear to be any clear evidence concerning the precentage of class members who do not file claims, or the reasons that class members choose not to file claims.

[75] Low settlement values could also be explained in part by other factors, such as the time value of money. "To the extent that the defendants can procrastinate, the present value of the plaintiff's expected settlement declines.... [A]t a realistic discount rate, plaintiff's attorneys may lose more because of deferral than defendants must spend to achieve delay. If so, this factor would be known to both sides in advance and might produce bluffing behavior in the form of dilatory tactics by the defendants that ultimately reduce settlements." John C. Coffee, Jr., Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions, 86 Colum. L.Rev. 669, 703 (1986)(hereafter "Coffee").

available. For example, Dunbar and Juneja found that cases in which issuers were joined by co-defendants such as accounting firms, law firms or underwriters settled for significantly higher amounts. They attributed this to the larger amount of insurance (as well as other assets) available in those cases.[76] Cooper Alexander suggested that "[t]he existence and operation of insurance and indemnification may be the most important factor in creating a system of settlements that do not reflect the merits." She noted that "both sides regard [insurance] as an independent source of funds and place a high value on preserving access to it. Insurance and (for the individual defendants) indemnification by the corporation are also important to defendants as a way of shifting their legal costs to others. Both of these important sources of recovery are available to fund a settlement, but not to pay a judgment."[77]

Relationship to Merits. Cooper Alexander's study provides some evidence that the merits matter very little, if at all, but her approach of isolating cases that were as factually similar as possible resulted in a sample of cases that may be too small, and too old, to clearly represent the larger universe of securities litigation. The Dunbar-Juneja study, and the Drake-Vetsuypens article offer qualified support to Cooper Alexander's hypothesis that the merits are not important in resolving securities litigation, but the Marino study offers some evidence in the other direction. The studies also do not clearly demonstrate what factors other than the merits might affect the outcome of securities litigation.

Stock Price Declines. There is also no clear evidence on the extent to which price declines drive securities class actions to be filed. The Drake-Vetsuypens study and the O'Brien study suggest that significant price declines

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[76] This is consistent with other information provided to the Subcommittee by Melvyn Weiss about settlements achieved in 66 cases in which his law firm was involved, which revealed that insurance carriers provided all or most of the payment for one or more settling defendants in at least 40 cases. This data is discussed at page 76 below.

[77] Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stanford L. Rev. 497, 550 (hereafter "Cooper Alexander"). Insurance coverage is uncertain in the event that a defendant loses at trial. This is because director and officer policies often contain exclusions for liabilities arising in securities offerings, and insurers often take the position that if the allegations in the complaint are sustained in court the policy was invalid because it was obtained by fraud. Id. at 551-52.

tend to precede lawsuits.[78] On the other hand, a draft study of the impact of shareholder litigation examined a pool of 51 firms in the biotechnology, computing, electronics and retail industries that were thought to potentially be "at risk" of being sued during 1988-92 because of drops in sales or earnings of over 20 per cent. The draft report finds that only one of these 51 firms was sued, even though their sales and earnings declines were about 50 per cent larger than the declines of 43 other firms in the same industries that were sued in the same period.[79]

B. Role of Courts In Screening Out Cases

The Federal Rules of Civil Procedure contain several provisions which provide courts with tools with which to address frivolous cases, as well as other cases which, while not necessarily frivolous, may lack a sufficient evidentiary basis to warrant proceeding to trial. Because of the use of these tools and pre-trial settlements (which are widely encouraged by courts) it is estimated that only 5 per cent of all civil cases filed in federal court proceed to trial.[80]

Data from sources aligned with both the plaintiffs' and defendants' side of securities litigation suggests that dismissals under various procedural tools play a decisive role in much securities litigation. For example, according to Melvyn Weiss, out of 229 securities cases brought by his firm over the past three years alleging violations of Section 10(b) of the Exchange Act, 21 have been voluntarily dismissed and 18 have been dismissed pursuant to motion.[81] According to information provided to the Subcommittee and the SEC by the six largest accounting firms, the total number of cases against auditors dismissed by federal and state courts rose from 23 in 1990 (compared to 192 new cases

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[78] See Appendix A, at pages 155-59.

[79] Jennifer Francis, Donna Philbrick and Katherine Schipper, Shareholder Litigation and Corporate Disclosure Strategies (April 1994 draft) at 1-2 (copy on file with Subcommittee staff).

[80] Cooper Alexander, supra note 77, 524, citing Annual Report of the Director, Administrative Officer of the United States Courts, 1987 REPORTS OF THE PROCEEDINGS OF THE JUDICIAL CONFERENCE OF THE UNITED STATES, at 211.

[81] In ten of the cases dismissed by trial courts Mr. Weiss's firm currently has appeals pending. Weiss letter, supra note 56, at Exhibit 2.

filed) to 79 in 1992 (compared to 141 cases filed).[82] In audit-related cases alleging federal securities law claims, the number of dismissals rose from 7 to 25, and in audit-related cases where the only legal claim was under Section 10(b) of the Exchange Act, the number of dismissals rose from 5 to 14.[83]

Among other procedural mechanisms, Rules 9(b) and 11 of the Federal Rules have been particularly significant. In assessing whether frivolous litigation is a problem under the federal securities laws, it is necessary to consider whether these rules are successful in deterring or screening out any such cases.

1. Rule 11

Prior to its amendment late in 1993, Rule 11 stated that an attorney's signature on a pleading, motion or other paper filed with the court constitutes that attorney's certification that the information is "well grounded in fact and is warranted by existing law ... and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation" and stated that if "a pleading, motion or other paper is signed in violation of this rule, the court, upon motion or upon its own initiative, shall impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, motion, or other paper, including a reasonable attorney's fee."[84]

According to some critics of the current securities litigation system, Rule 11 has not been an effective answer to frivolous litigation. They argue that the cost of pursuing a motion under Rule 11 is so high, and the likelihood of success so small, that plaintiffs filing frivolous cases have little to fear from the Rule. These critics point to cases in which courts explicitly found that claims

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[82] See "A Disproportionate Burden of Liability," Table VIII, attached to letter from Mark H., Gitenstein and Andrew J. Pincus to Martha L. Cochran, Staff Director, Securities Subcommittee, June 11, 1993 (hereafter ("Big Six study"), Hearing Record at 672. By comparison, the number of audit-related cases filed in those years decreased notably, from 192 in 1990 to 141 in 1992. Id.

[83] Big Six study, supra note 82, at Table VIII.

[84] Rule 11, Fed.R.Civ. P. 11 (1992).

were groundless, and yet refused to impose sanctions.[85] These critics also contend that sanctions imposed by courts are often insufficient to deter frivolous litigation.[86] Moreover, critics point out that fee awards under Rule 11 do not apply to appeals of such awards, even if they are upheld on appeal.[87]

Securities litigation critics also point out that Rule 11 in its present form recently has been altered in a way which may weaken its current deterrent effect. Pursuant to the Rules Enabling Act,[88] the Supreme Court entered an order on April 22, 1993 proposing amendments to Rule 11 and other provisions of the Federal Rules of Civil Procedure. These amendments went into effect on December 1, 1993. The amendments to Rule 11, among other things, make the award of sanctions permissive rather than mandatory, permit attorneys to withdraw pleadings within 21 days of service of a motion for sanctions without penalty, and limit awardable costs to those "directly and unavoidably caused by the violation."[89]

Although the recent amendment to Rule 11 may narrow its scope in several respects,[90] this provision continues to give federal judges some

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[85] Letter from Mark H. Gitenstein to Martha L. Cochran, August 18, 1993, at 4 (citing Hecklin v. Weatherly Securities, Inc. 1989 U.S. Dist. LEXIS 3586, *2-*3 (E.D. Pa. 1989); Harlyn Sales Corp v. Investment Portfolios, Inc., 142 F.R.D. 671 (N.D. Ill. 1992); Panio v. Beverly Enterprises, Inc., 1989-90 Sec. Cas. (CCH) at ¶ 95,007 (S.D.N.Y. 1992); Cahill v. Arthur Andersen & Co., 659 F. Supp. 1115 (S.D.N.Y. 1986). Mr. Gitenstein is an attorney who represented the AICPA and the six largest accounting firms in connection with the Subcommittee's hearings.

[86] Courts are not required under Rule 11 to impose actual fees, only reasonable fees to show that the defendant "correlated his response, in hours and funds expended, to the merit of the claims." Thomas v. Capital Security Service, Inc., 836 F.2d 866, 878 (5th Cir. 1988) (en banc).

[87] Letter from Mark H. Gitenstein to Martha L. Cochran, August 18, 1993 at 5 (citing Cooter & Gell v. Hartmarx Corp., 496 U.S. 384, 404-08 (1990).

[88] 28 U.S.C. §2702.

[89] Fed. R. Civ. P. Rule 11 (1993).

[90] As amended, Rule 11 continues to require that attorneys or parties conduct a reasonable inquiry into the factual and legal basis of any pleading or motion. However, the sanctions which follow from violating the rule are now significantly different. Courts are no longer required to impose sanctions for violations, and an attorney or party escapes

authority and discretion to assess fees, including attorneys' fees, upon attorneys and their clients who commence frivolous legal actions. Moreover, in securities cases brought under the Securities Act, Section 11(e) of the Act also continues to be a basis for imposing attorneys' fees and costs on parties who assert a groundless position.[91]

The view that Rule 11 has been ineffective is challenged by others, who argue that Rule 11 (at least prior to its recent amendment) has not only deterred frivolous litigation, but has been too effective, by deterring "disfavored lawsuits" such as civil rights cases and securities cases.[92] This view is supported by written comments by the Advisory Committee on Civil Rules of the Judicial Conference of the United States, in recommending the recently adopted amendments to Rule 11. The Advisory Committee expressed concern that Rule 11 has been used to sanction plaintiffs more than defendants, and

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liability for a sanction if he withdraws the offending document less that 21 days after a motion for sanctions is filed. The sanction imposed "shall be limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated.... [T]he sanction may consist of, or include, directives of a nonmonetary nature, an order to pay a penalty into the court, or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of some or all of the reasonable attorney's fees and other expenses incurred as a direct result of the violation." Fed. R. Civ. P. 11(c) (1993).

[91] Section 11(e) of the Securities Act provides in part:

> "In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit...."

[92] Letter from Jonathan W. Cuneo to Martha L. Cochran, September 9, 1993, at 3 (citing Vairo, Rule 11: Where Are We Now and Where Are We Going?, 60 Ford. L. Rev. 475, 483 (1991)).

has deterred parties from asserting novel theories or alleging facts which it believes are true but which require discovery in order to be determined.[93]

The Subcommittee has not learned of any empirical studies focused on Rule 11 as it applies to securities class actions. However, two detailed studies of the application of Rule 11 suggest that the Rule has had a generally beneficial impact in deterring some frivolous civil litigation.

AJS Survey An empirical survey sponsored by the American Adjudicature Society of nearly 4500 trial lawyers suggests that Rule 11 has played a role in shaping attorneys' behavior, and has had a broader impact than could be measured by simply considering how many times sanctions were imposed. 32 per cent of the respondents said that during the past 12 months they had chosen to do or not do something because of concern about possible Rule 11 exposure, and 19 per cent said that they had declined to take on a case, or had advised a client not to pursue or defend a case, because of Rule 11 concerns.[94]

This survey broke out results for particular categories of cases, including "other commercial," a category which included securities litigation together with 11 other types of commercial litigation.[95] The survey found that the impact of Rule 11 on plaintiff's attorneys and defense attorneys in this category was similar. For example, 28 per cent of plaintiff's attorneys and 31 per cent of defense attorneys who spent more than 50 per cent of their time on "commercial" work reported that within the past year they had made specific reference to Rule 11 in trying to discourage a client from pursuing a course of action. Moreover, 41 per cent of "commercial" plaintiff's attorneys and 47 per cent of "commercial" defense attorneys reported that within the past year they

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[93] See Committee Notes to proposed amendments to Federal Rules of Civil Procedure, at vi-vii. The Committee also expressed concern that courts have relied on cost-shifting rather than non-monetary sanctions as the normative sanction; that the rule creates little incentive for a party to abandon positions after they are no longer tenable under the facts or the law; and that it has created conflicts between attorneys and their clients and more contentious behavior between attorneys; and that too much time has been spent by litigants dealing with such motions. Id.

[94] Lawrence C. Marshall, Herbert M. Kritzer and Frances Kahn Zemans, The Use and Impact of Rule 11, 86 Nw. U. L. Rev. 943, 961 (1992) (hereafter "AJS study").

[95] The authors of the survey noted that a disproportionate number of Rule 11 sanctions were imposed in "other commercial" and civil rights cases. Although "other commercial" cases consisted of 9.8 of federal cases filed, they accounted for 18.7% of the cases in which sanctions were imposed. AJS study, supra note 94, at 966.

had performed an extra pre-filing review of a pleading or motion because of Rule 11.

This survey also found that 70 per cent of Rule 11 sanctions were imposed on the plaintiff's side, and that the most common reason for imposing sanctions was the filing of allegedly frivolous suits or claims.[96] Despite reports that Rule 11 had spawned a "cottage industry of sanction-seeking," the survey found that even in cases where sanctions were imposed, 65 per cent of those surveyed had spent less than 10 hours preparing or responding to a Rule 11 motion. Although 95 per cent of sanctions imposed were monetary, 45 per cent of sanctions imposed were fines of under $1500.[97]

FJC Survey A survey of nearly 600 federal judges by the Federal Judicial Center found that 80 per cent of judges thought that Rule 11 has had a positive impact on litigation in federal courts, 72 per cent of judges thought the benefits of the Rule outweighed the expenditure of their time on Rule 11 motions, and only 5 per cent thought the rule impeded development of the law. 75 per cent of the judges surveyed also thought that frivolous litigation was a small problem or no problem at all, and only 10 per cent thought that Rule 11 was very effective in deterring the filing of groundless pleadings. Most judges believed that prompt rulings on summary judgment motions and motions to dismiss were more effective in dealing with frivolous litigation than Rule 11 sanctions. 80 per cent of the judges thought Rule 11 was only moderately effective, slightly effective or not effective at all in deterring groundless factual allegations in a complaint.[98]

Testimony The SEC's testimony to the Subcommittee cited surveys of court dockets and federal judges that showed that Rule 11 issues were raised in less than 3 per cent of federal cases, and that most judges believed that frivolous litigation was not a major problem and could be dealt with through prompt dismissals.[99] According to Professor Seligman, in recent years courts have dealt with frivolous or excessive litigation in many respects, such as

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[96] Id. at 953.

[97] Id. at 958.

[98] Rule 11: Final Report to the Advisory Committee on Civil Rules of the Judicial Conference of the United States, by the Federal Judicial Center (1992), Section 1A at 1-2, Section 2A at 5, 8.

[99] McLucas statement, Hearing Record at 114-15.

increased use of motions to dismiss cases that do not plead fraud with particularity and increased willingness to sanction attorneys for frivolous litigation under Section 11(e) of the Securities Act or Rule 11.[100]

Mark Griffin, the Director of the Division of Securities of the Utah Department of Commerce, also indicated that courts currently appear to have the tools necessary to deter frivolous suits. He noted that a detailed study of Rule 11 found that it was prompting more factual investigation, and that the Civil Justice Reform Act of 1990, which requires courts to draw up plans to streamline civil discovery, may also ease whatever impact frivolous litigation might have.[101]

2. Rule 9(b)

Rule 9(b) of the Federal Rules of Civil Procedure requires plaintiffs to plead allegations of fraud "with particularity." Because it imposes a higher standard for pleading fraud than is required under the Federal Rules for other types of allegations, this provision is cited by many observers as a particularly significant device for curtailing frivolous litigation under the anti-fraud provisions of the securities laws. In combination with the number of elements which plaintiffs must plead and prove in order to win an anti-fraud case under the federal securities laws, Rule 9(b) can be significant in screening out frivolous cases. However, some observers have pointed out that Rule 9(b)'s effectiveness as a tool to weed out frivolous cases may be undermined by a split in the circuits concerning how to apply Rule 9(b).

A number of the circuits have held that a plaintiff does not have to specify facts in its complaint demonstrating that the defendant acted with scienter.[102] The First, Third, Ninth and Tenth Circuits have held that allegations of scienter can be pled generally, without reference to any specific facts. For example, in one case a district court decision dismissed a claim under Rule 9(b) because the allegations "not only failed to support but tended to negate the general averment of knowledge." The First Circuit Court of Appeals reversed on the basis that Rule 9(b) did not require facts from which

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[100] Seligman statement, Hearing Record at 131.

[101] Prepared statement of Mark J. Griffin, Hearing Record at 128.

[102] Scienter is a required element in actions under the anti-fraud provisions of the federal securities laws. Scienter is defined as "a mental state embracing intent to deceive, manipulate or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

knowledge could be inferred.[103] In another case, the Third Circuit reversed a district court dismissal under Rule 9(b), holding that allegations that "defendants... participated, and/or aided or abetted, and/or failed to discover when in the exercise of due diligence they would have discovered, devices to defraud...." were sufficient to allow the case to proceed.[104]

The Second and Seventh Circuits, by contrast, interpret Rule 9(b) to require citation to specific facts supporting allegations of scienter. This can be established through information available from public sources. For example, a district court in the Seventh Circuit held that corporate officer's positions within the company supported the inference that they "were privy to the adverse information alleged in the plaintiffs' complaint" and "had reason to downplay its effects given their direct accountability for the company's performance."[105] Similarly, a district court in the Second Circuit found that a complaint alleged scienter with particularity where corporate executives with large equity and option positions had a motive to "continue and prolong the illusion of AnnTaylor's successful growth and management and inflate the price of [its] securities."[106]

Despite the split in the circuits over how to apply Rule 9(b), there is evidence that in recent years courts have begun to use Rule 9(b), as well as motions for summary judgment and motions to dismiss, to screen out a greater number of securities cases. For example, the number of cases dismissed against major accounting firms increased from 23 in 1990 to 29 in 1991, to 79 in 1992.[107] A broad empirical study of securities class actions resolved over the past two years showed the number of cases dismissed rising from 15 to

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[103] McGinty v. Beranger Volkswagen, Inc., 633 F.2d 226, 228 (1st Cir. 1980).

[104] Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 272-73 (3d Cir. 1978).

[105] Kas v. Caterpillar, Inc., 815 F. Supp. 1158, 1165 (C.D. Ill. 1992). See also Morse v. Abbott Laboratories, 756 F. Supp. 1108 (N.D. Ill. 1991).

[106] In re AnnTaylor Stores Securities Litigation, 807 F. Supp. 990, 1001 (S.D.N.Y. 1992).

[107] Big Six study, supra note 82, Table VIII. By way of comparison, in those three years the number of cases filed against those accounting firms was 192, 172 and 141 respectively. Id.

24.[108] A wide variety of observers have agreed that courts are more aggressively dismissing securities cases on the pleadings.[109]

C. Impact of Litigation on Financial Reporting by Companies

One criticism of the current litigation system is that it may chill the willingness of companies to voluntarily disclose financial information to the market. For example, John G. Adler, testifying on behalf of the American Business Conference, stated that

> "[m]any firms in Silicon Valley, and, I suppose, elsewhere, have adopted a 'no communications' policy. That means they say nothing beyond what they must disclosure by law. That strategy limits the ability of investors to make informed choices and seems to me wrong as a matter of principle. Nevertheless, 'no communications' makes perfect sense if the goal is to avoid situations that might lead to a class action lawsuit."[110]

Jake L. Netterville, the Chairman of the Board of the American Institute of Certified Public Accountants ("AICPA") testified that litigation exposure of accountants has driven many accounting firms to avoid assuming new responsibilities for auditing voluntary financial disclosures such as financial projections, and to oppose efforts by the AICPA to require accountants to undertake broader responsibilities.[111]

Notwithstanding the claim that securities litigation chills voluntary corporate disclosure, other observers point out that private liability is an important underpinning of the financial disclosure system. Mr. McLucas from the SEC noted that "[t]here is a substantial danger that market confidence will

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[108] See Dunbar-Juneja study, supra note 72, Table I.

[109] See More Companies Succeed in Defending Charges They Defrauded Investors, Wall St. J., April 30, 1992, B-1; Pitt & Groskaufmanis, Directors' Liability: No Fraud By Hindsight, 'Tips for Taking the Sting Out of Shareholder Suits', Jan./Feb. 1993 The Corporate Board, The Journal of Corporate Governance. See also Response to Written Questions of Senator Sasser From William S. Lerach, Hearing Record at 269-70.

[110] Adler statement, Hearing Record at 104.

[111] Prepared Statement of Jake L. Netterville, Hearing Record at 348.

be eroded if investors are unable to vindicate their rights."[112] Other securities law experts cite the broad success of the American securities markets as ultimate proof that the disclosure system is reinforced by private securities litigation. This argument was succinctly made by Professor Seligman:

> "One reason that the United States has achieved its current success in capital formation and breadth of securities ownership is the federal securities laws' mandatory disclosure system, as enforced by Government and private litigation. It is significant, I believe, that the United States both has the broadest stock ownership and the most demanding disclosure system.... The mandatory disclosure system has performed a significant role in maintaining investor confidence in the securities markets and deterring securities fraud.... Private litigation performs a significant role in enforcement of the mandatory disclosure system. Former SEC Chairman David Ruder noted in 1989 that in recent years less than 10 per cent of cases involving securities or commodities have been brought by the Government."[113]

Kasznik-Lev Study A recent study by Ron Kasznik and Baruch Lev of the University of California reviewed the characteristics of disclosures made by 530 public companies prior to announcing large "earnings surprises." They concluded that the voluntary disclosures were skewed toward bad news announcements. For example, they found that firms were 2 1/2 times as likely to voluntarily make negative sales or earnings disclosures as they were to make positive sales or earnings disclosures. Kasznik and Lev concluded that litigation exposure was a likely force shaping firms' disclosure policies.[114]

Kasznik and Lev's study, while significant, may not be conclusive. For example, Kasznik and Lev apparently identified "earnings surprises" by

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[112] McLucas statement, Hearing Record at 114.

[113] Seligman statement, Hearing Record at 43.

[114] Ronald Kasznik and Baruch Lev, "The Characteristics and Consequences of Corporate Discretionary Disclosures," May 1993, Hearing Record at 675-76 (hereafter, "Kasznik-Lev study"). A draft study by another group of academics concludes that "we did not find evidence of a simple causal relation between the presence or magnitude of adverse earnings reports and the incidence of shareholder litigation." Jennifer Francis, Donna Philbrick and Katherine Schipper, Shareholder Litigation and Corporate Disclosure Strategies, (April 1994 draft) at 30-31 (on file with Subcommittee staff).

comparing earnings announcements to earnings forecasts made by analysts.[115] It is unclear why they used this as a benchmark of "earnings surprise" rather than movement in stock price after the announcement. The study also only states that companies "experiencing relatively large earnings surprises" were included, without specifying the threshold for "relatively large."[116]

Kasznik's and Lev's conclusions also appear open to some questions. They settle on the explanation that companies are engaged in "defensive behavior against a perceived threat of litigation. Specifically, managers concerned, among other things, with the personal implications of litigation... decrease their exposure to litigation by restricting voluntary disclosure of information, particularly of good news."[117] Few other potential explanations for the discrepancy between disclosure of bad news and good news are considered. For example, they do not discuss the possibility that in some instances companies might be in the process of registering new stock offerings with the SEC, and might be concerned that disclosure of good news could be viewed as "gun jumping."[118] Kasznik and Lev also do not address what impact a reduction in litigation exposure might have on voluntary disclosure. Their study sheds no light on whether such a reduction would result in a more

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[115] Kasznik-Lev study, supra note 114, Hearing Record at 681. Kasznik and Lev relied on analyst reports as reported by a service that collects analyst reports by company. It is unclear if Kasznik and Lev's counted announcements as "surprises" only when they differed from consolidated analyst forecasts, or whenever they differed from forecasts by some analysts.

[116] Id.

[117] Id., Hearing Record at 698.

[118] It may be that the discrepancy between reporting good news and bad news may be explained in part by proper accounting practices, which might encourage using earnings estimates, for example, that tend to be lower than actual results. Another explanation for the discrepancy between good news announcements and bad news announcement may simply be that adverse developments tend to be more dramatic and therefor newsworthy, and good news more incremental. In other words, companies may tend to voluntarily disclose more bad news than good news for the same reasons that newspapers tend to report more bad news than good news.

balanced voluntary disclosure of both good and bad news, or whether it would result in more or less voluntary disclosure of any kind.[119]

Conclusions about impact on disclosure. The statements by corporate executives and others that securities litigation may in some respects discourage companies from disclosing information other than as required by law suggests that securities litigation may be working at cross-purposes to the fundamental objectives of the securities laws. The countervailing argument is also compelling that potential securities litigation has on balance reinforced the disclosure system, which in turn helped American securities markets to become the largest and most open in the world.

Whether private securities litigation has a net positive or negative effect on corporate disclosure goes to the heart of the federal securities laws. The testimony and submissions provided to the Subcommittee do not provide a clear answer. Since the relationship between private securities litigation and financial disclosure is integral to the success of the securities markets of the United States, it may be desirable for the SEC, academics or other disinterested parties to further study the impact of private securities litigation on the financial disclosure system.[120]

D. Possible New Tools

1. Fee Shifting

A number of critics of private securities litigation have suggested that some mechanism for shifting attorneys' fees and costs onto the losing party might be an effective way of deterring frivolous litigation. The most far-reaching suggestions have been to adopt the "English Rule", under which the losing party bears the attorneys' fees and costs of the prevailing party (as

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[119] Other observers have hypothesized that excessive litigation exposure would lead to less disclosure of any kind, rather than a bias toward positive of negative disclosure. "[A] firm that discloses information in the aftermarket as it goes along inevitably takes the risk of excessive optimism and excessive pessimism. A rule that penalizes excesses in either direction would lead to quiet, not (necessarily) to an increase in the world's portion of truth." Frank H. Easterbrook and Daniel R. Fischel, Optimal Damages in Securities Cases, 52 U. Chi. L. Rev. 611, 640 (1985) (hereafter "Easterbrook and Fischel").

[120] The SEC also brings civil actions in this area, and corporate disclosure practices may be influenced as much or more by the threat of SEC enforcement actions than by potential private actions.

distinct from the "American Rule", in which each party bears its own costs). A number of witnesses at the Subcommittee hearing commented on the "loser pays" system of fee-shifting, as well as alternative approaches. For example, the SEC advised the Subcommittee that

> "any fee-shifting provision that is added to the Exchange Act should be limited in application to claims and defenses that are held by a court to be without merit. If not so limited, a fee-shifting provision would inevitably deter defrauded investors with meritorious claims from seeking compensation for their damages. In class action litigation in particular, individual plaintiffs frequently have only a nominal stake in the action's outcome. Such plaintiffs could not afford to risk liability for defendant's legal fees given their small interest in the potential recovery."[121]

Melvyn Weiss also warned of potentially serious consequences if proposals for an "English Rule" form of fee-shifting were adopted:

> "The adoption of the English Rule.... would end virtually all private litigation under the federal securities laws, since no sane defrauded investor would bring a lawsuit if it were even remotely possible that he or she could be held liable for all of defendants' costs if they lost -- even on a technicality. By all accounts, the system in England -- even with a vast legal aid safety net -- has major problems. I see no public policy reason to emulate it, particularly when the English are in some cases moving toward an American Rule."[122]

In addition to potentially discouraging some meritorious claims, there may be other problems with the "English Rule" as it is applied in England. Unlike the United States, where plaintiffs' attorneys normally only get paid a percentage fee based on a successful outcome, attorneys in England get paid the same amount regardless of outcome. Consequently, the English system has been criticized for not providing sufficient incentives for skill and efficiency by barristers and solicitors. Moveover, it appears that the "English Rule" is often

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[121] McLucas statement, Hearing Record at 118. As an alternative to the "loser pays" approach, the SEC suggested that Section 10(b) of the Exchange Act could be amended to include a fee-shifting provision similar to one contained in Section 11 of the Securities Act.

[122] Weiss statement, Hearing Record at 410.

not applied in England, because more than half of the population is protected against fee shifting by a government-funded legal aid program or by trade unions.[123]

At least two possible alternative fee-shifting approaches have also been suggested. One approach, embodied in a bill introduced by Senator Domenici and Senator Sanford in the 102nd Congress, would require courts to require the losing party to pay the prevailing party's attorneys' fees and other expenses unless the court makes an affirmative determination, based on the record, that the losing party's position was "substantially justified."[124] In addition, such a fee award can only occur if the court had preliminarily ruled earlier in the litigation that such an award might be appropriate.

The "substantially justified" approach has received broader support than the "English Rule" approach.[125] Nevertheless, some observers have expressed concern that this standard is also too broad and could discourage middle-class investors from bringing legitimate cases.[126] This concern is underscored by the way the term "substantially justified" is used in the Equal Access to Justice Act ("EAJA"), from which it originated. As used therein, attorney's fees and costs can be applied against the United States in actions in which the litigation position of the federal government is determined by the court not to have been "substantially justified."[127] It is noteworthy that the "substantially justified "standard under the EAJA does not apply against litigants other than the government, and that attorneys' fees and costs may only be recovered under the "substantially justified" standard if the party seeking the sanction is an individual with a net worth of under $200,000, by a tax-exempt organization,

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[123] See Napier, For Many, English Rule Impedes Access to Justice, Wall St. J., Sept. 24, 1992, at A-17. See also Lerach statement, Hearing Record at 145-46.

[124] The term "substantially justified" is borrowed from the Equal Access to Justice Act, Pub. L. No. 96-481, 94 Stat. 2325 (1980)(codified in 5 U.S.C. § 504 and 28 U.S.C. § 2412).

[125] See letter from Richard C. Breeden, Chairman, Securities and Exchange Commission, to Senator Pete V. Domenici, August 12, 1992, at 3 (expressing personal support for "substantially justified" approach).

[126] Griffin statement, Hearing Record at 130.

[127] Although the term "substantially justified" is not defined in the EAJA, the statute makes it clear that it is a higher standard than would apply under Rule 11 of the Federal Rules of Civil Procedure. Equal Access to Justice Act, as amended, 5 U.S.C. § 504(a)(1) and 28 U.S.C. § 2412(d)(1)(B).

or a business entity with a net worth of under $7 million and fewer than 500 employees. Therefore, the "substantially justified" standard is carefully limited in the EAJA in such a way that there is virtually no likelihood of deterring legitimate claims from being brought.

Another approach to fee-shifting which has been proposed involves extending a fee-shifting standard which already exists for several private rights of action expressly set out in the federal securities laws. For example, Section 11 of the Securities Act provides that, in actions brought under any provision of the Securities Act, a party may be required to pay costs and reasonable attorneys' fees if "the court believes the suit or defense to have been without merit." Courts have read this provision to be similar or identical to the fee-shifting standard under Rule 11.[128]

As discussed at pages 38-39 above, a study by the American Adjudicature Society suggests that prior to the amendment of Rule 11 last fall, that provision had a significant effect on the conduct of counsel for commercial litigants, prompting many attorneys to give extra care before filing pleadings or motions, and encouraging attorneys to try to dissuade clients from pursuing particular courses of conduct. Since the amendment of Rule 11 last year, it is questionable whether the current version of the rule will continue to have this salutary effect. Consequently, extending the fee-shifting provision which governs express causes of action to implied actions under Section 10(b) appears to be a measured response to the threat of abusive litigation practices which should not discourage pursuit of meritorious cases.

2. Alternative Dispute Resolution

One possible approach to screening out frivolous litigation more efficiently would be to encourage the use of a non-judicial forum to resolve disputes concerning allegations of securities fraud. A number of commentators have urged the Subcommittee to consider ways of encouraging greater use of some form of "alternative dispute resolution" ("ADR") in private securities litigation.[129] According to these proponents, various types of ADR could

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[128] "The standard in Rule 11 is that same as that applied under §11(e), which gives the court 'broad discretion to consider and balance the relevant facts and policies.'" 10 L. Loss & J. Seligman, Securities Regulation 4653 (1993) (citations omitted).

[129] See, e.g., letter from Barry K. Rogstad, President, American Business Conference, to Senator Christopher J. Dodd Nov. 1, 1993.

greatly reduce the time and expense of resolving securities litigation. They suggest that such an approach would have benefits both in reducing the burden of frivolous securities litigation, and in providing investors in meritorious cases with a quicker resolution with less reduction of any potential recovery by attorneys' fees and other litigation expenses.

ADR is a broad term encompassing a number of procedures for resolving legal disputes without utilizing the facilities of the judicial system, such as arbitration, mediation or mini-trials. Although ADR was traditionally been viewed with some suspicion by courts and policy makers, in recent decades it has come to be regarded with greater favor for a number of reasons, including a backlog of cases in civil courts, increasing costs of litigation, and a growth in understanding about and sophistication of ADR techniques.[130]

Legislative Recognition of ADR Several recent legislative developments have given greater impetus to ADR to resolve claims in federal courts. In 1990 Congress passed the Administrative Dispute Resolution Act, which required federal agencies to develop policies incorporating alternative dispute resolution methods into, *inter alia*, civil and administrative enforcement actions.[131] The Civil Justice Reform Act ("CJRA"), also enacted in 1990, mandates that each federal district court, after study by an advisory group, shall implement a plan to reduce the expense and delay in civil litigation. The CJRA specifies that in formulating its plan, each district court should consider ADR programs, particularly "a neutral evaluation program for the presentation of the legal and factual basis of a case to a neutral court representative selected by the court at a nonbinding conference conducted early in the litigation.[132] In addition,

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[130] *Compare* *Wilko v. Swann*, 346 U.S. 427, 435-36 (1953) (invalidating contractual agreement to arbitrate claim under Securities Act based in part on Court's conclusion that arbitration would not adequately protect customer's rights) *with* *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S.Ct. 1917, 1922 (1989)(reversing *Wilko* and observing that "[o]nce the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not ... essential features of the Securities Act."

[131] Agencies' policies are also required to address the use of ADR in disputes concerning rulemakings, issuing or revoking licenses, contract administration, or other agency actions. Administrative Dispute Resolution Act, 101 Pub.L.No. 101-552, § 3(a) (1990).

[132] 28 U.S.C. § 473(b)(4). *See also* 28 U.S.C. § 473(a)(6). The CJRA also established a "demonstration program" commencing January 1, 1991. Under the program, the district courts for the Northern District of California, Northern District of West Virginia and

Rule 16(c) of the Federal Rules of Civil Procedure was amended effective December 1, 1993 to authorize federal courts to consider and apply ADR in appropriate cases.[133]

ADR and SEC Disgorgement Funds. The growing use of ADR is also illustrated by a recent settlement reached between the SEC and Prudential Securities, Inc.[134] In that case, the SEC brought and simultaneously settled a federal court action and administrative proceedings against Prudential charging it with wide-ranging violations of the federal securities laws in connection with Prudential's sales of limited partnership investments from 1980 to 1990. Prudential settled the matter by agreeing to pay $41 million in fines and $330 million into a fund for the benefit of

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Western District of Missouri are to conduct a four-year "experiment with various methods of reducing cost and delay in civil litigation, including alternative dispute resolution...." 101 Pub. L. No. 650, §104(b).

The program introduced by the Western District of Missouri included a requirement that one-third of civil cases be referred automatically to mandatory non-binding ADR, and provided sanctions for parties who did not participate in good faith in ADR. A commentator has questioned whether the CJRA authorizes a court to promulgate such a requirement if it varies from the Federal Rules of Civil Procedure. Tobias, Judicial Oversight of Civil Justice System, 140 F.R.D. 49 (1992).

[133] Fed. R. Civ. P. 16(c). The rule, which concerns pretrial conferences, now states that consideration may be given, and the court may take appropriate action, with respect to ... (9) settlement and the use of special procedures to assist in resolving the dispute when authorized by statute or local rule;..."

The Judicial Conference of the United States, under whose auspices the new language was drafted, elaborated on the purpose of these provisions:

> "Paragraph 9 is revised to describe more accurately the various procedures that, in addition to traditional settlement conferences, may be helpful in settling litigation. Even if a case cannot immediately be settled, the judge and attorneys can explore possible use of alternative procedures such as mini-trials, summary jury trials, mediation, neutral evaluation, and nonbinding arbitration that can lead to consensual resolution of the dispute without a full trial on the merits. The rule acknowledges the presence of statutes and local rules or plans that may authorize use of some of these procedures even when not agreed to by the parties." Fed. R. Civ. P. 16 (Notes of Advisory Committee).

[134] SEC v. Prudential Securities, Inc., SEC Litigation Release No. 13840 (October 21, 1993).

investors. The settlement provided for a non-judicial claims resolution process under the direction of a court-appointed administrator.

Under the process. Prudential is required to notify investors of the availability of the claims process. Investors can then submit claims to Prudential. For any claims which Prudential does not offer to pay in full, investors can pursue their claims in arbitration proceedings overseen by the administrator, or can elect to proceed in federal court.[135] The result of any arbitration would be non-appealable and binding on all parties. The claims fund would be used to pay all awards, judgments and settlements arising out of arbitration or litigation based on the limited partnership investments, but could not be used to pay attorney's fees. Any undistributed portion of the settlement fund will be paid to the U.S. Treasury.

* * *

Not all types of ADR are necessarily practical in all settings. Various types of ADR may result in lower litigation costs, expedited resolution of the dispute, preserving a better working relationship among the disputants, better substantive outcomes, and more controlled disclosure of sensitive information produced in discovery. However, even advocates of ADR recognize that it does not always produce these benefits relative to litigation, and may sometimes even result in higher costs and more delay than litigation would produce.[136] Some of the possible advantages and disadvantages of the approaches to ADR which have been mentioned in the securities law context are discussed below.

Arbitration, the most widely used form of ADR, has been used as an alternative to litigation for centuries. Arbitration has been firmly established in the United States as an alternative to litigation at least since 1925, when Congress enacted the Federal Arbitration Act, which authorized federal courts to compel parties to honor contractual agreements to arbitrate,

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[135] As part of the settlement, Prudential agreed to waive any statutes of limitation defense in arbitration. This waiver does not apply to claims pursued in federal court.

[136] For a more detailed discussion of the potential advantages and drawbacks of ADR in securities litigation, see Ralph C. Ferrara and Danny Ertel, Beyond Arbitration: Designing Alternatives to Securities Litigation, 48-66 (Butterworth Legal Publishers 1991) (hereafter "Ferrara and Ertel").

and required federal courts to stay proceedings in disputes subject to an enforceable arbitration agreement.[137]

In the context of securities law disputes, arbitration has become prevalent in the area of broker-customer disputes since the Supreme Court held in 1987 that disputes under the Exchange Act were subject to binding arbitration agreements entered into by the parties before the dispute arose.[138] Binding arbitration agreements are now almost universal between securities brokers and their customers. These arbitration proceedings are conducted under the auspices of securities self-regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers, under procedural rules approved by the SEC.[139]

Under these procedural rules, securities arbitration operates as a sort of streamlined litigation. An arbitration is initiated by a customer or broker filing a statement of claim. The responding party has 20 days in which to file an answer to the claim. The Director of Arbitration at the forum (either a self-regulatory organization or the AAA) selects either a single arbitrator or panel of arbitrators and designates a chairman for the panel. The arbitrator (or a majority of the arbitration panel) usually comes from outside the securities industry but is familiar with how the industry works. The parties are advised in advance of the arbitrators selected and are provided with information on their backgrounds. The parties have an opportunity to remove one arbitrator for any reason and to remove additional arbitrators for cause. Hearings follow a case presentation format similar to a trial, with opening statements, witnesses and other evidence, cross-examination and closing statements. A record is kept of the hearing. Arbitrators are encouraged to render their

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[137] 9 U.S.C. § 1 et seq.

[138] Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987). The number of arbitrations between securities brokers and their customers rose 540 per cent between 1980 and 1990. By comparison, securities trading volume in securities listed on NASDAQ increased by 400 per cent over that period, and by 250 per cent for securities listed on the New York Stock Exchange. See Securities Arbitration: How Investors Fare, Report by the General Accounting Office, May 1992, (hereafter "GAO Report") at 18.

[139] These procedural rules are modeled on the Uniform Code of Arbitration, which was developed in 1977 by representatives of the securities industry with the encouragement of the SEC. In addition, a number of securities arbitrations are conducted by the American Arbitration Association ("AAA"). While the AAA's rules are not subject to SEC approval, its rules are also similar to the Uniform Code.

decision within 30 days of the hearing. The decision does not have to set forth its reasoning. The arbitration decision is not appealable except for very limited issues such as lack of impartiality, fraud or disregard of the law.[140]

It should be noted that arbitration overseen by the self-regulatory organizations has been criticized as being biased against investors and as yielding inconsistent or even irrational results, with little or no opportunity for redress on appeal. A study of securities arbitration by the General Accounting Office found no evidence of a pro-industry bias. On the other hand, that study criticized as insufficient the procedures of arbitration forums designed to select independent and competent arbitrators.[141]

Early Neutral Evaluation was developed to provide a nonpartisan assessment of each side's claim early in litigation to enable the parties to better appraise settlement terms. The process

> "begins early, within three to four months after filing of the suit. It employs a neutral, and usually an experienced, volunteer from the local bar who has some expertise in the subject matter of the dispute. It brings the parties together, both lawyers and clients, and provides them with a nonbinding evaluation of their case after they have each presented brief written and oral arguments. These evaluations are shared with both parties, abut are deemed confidential among them and not subject to disclosure to the court or any other party. The neutral, in addition to providing an evaluation of the case, works with the parties to achieve a reasonable, expedited, cost-efficient discovery plan designed to help the parties prepare for more in-depth settlement negotiations."[142]

This approach appears to be similar to one endorsed by Professor Seligman in his testimony to the Subcommittee. Professor Seligman discussed his experience as a "disinterested person" appointed by a state court under a Michigan law to oversee discovery. According to Professor Seligman, "this may be the most promising area in which the transaction costs of private securities

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[140] For a more detailed description of the securities arbitration process, see the GAO Report, supra note 139, at 16-17.

[141] Id.

[142] Ferrara & Ertel, supra note 136, at 77-78.

litigation might be reduced without jeopardizing the ability of plaintiffs to litigate meritorious claims."[143]

Minitrial

"is a flexible, nonbinding settlement process primarily used out of court. In the past decade, it has been employed by some federal judges with some modifications.... [T]he court minitrial is a relatively elaborate ADR method generally reserved for large disputes. In a typical court minitrial, each side presents a shortened form of its best case to settlement-authorized client representatives -- usually senior executives. The hearing is informal, with no witnesses and a relaxation of the rules of evidence and procedure. A judge, magistrate judge or nonjudicial neutral presides over the one- or two-day hearing. Following the hearing, the client representatives meet, with or without the neutral adviser, to negotiate a settlement. At the parties' request, the neutral adviser may assist the settlement discussions by acting as a facilitator or by issuing an advisory opinion. If the talks fail, the parties proceed to trial."[144]

Mediation is an ancient tool of dispute resolution employed in areas from international diplomacy to labor disputes.

"At the most basic level, mediation is a very straightforward process characterized by certain key elements: the process brings the parties together with a neutral facilitator who generally has not authority to bind the parties to any particular result but whose role is to help effect agreement, and the mediator can attempt to do so by serving as anything from a conduit of information, to a nonbinding evaluator of claims, to an independent and creative source of settlement proposals....

"Mediation... can help the parties work toward better substantive outcomes than those which litigation might produce. The mediator can, for example, poll the parties confidentially and discover information they

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[143] Seligman statement, Hearing Record at 131-32. See also Seligman, The Disinterested Person: An Alternative Approach to Shareholder Derivative Litigation, 55 Law & Contemp. Probs. 357 (1992).

[144] National ADR Institute for Federal Judges, Judge's Deskbook on Court ADR (1993) at 25.

might not disclose to each other. By meeting privately with the parties, mediators have an opportunity to learn about the parties' interests and about their perceptions of the facts and of legitimate resolutions of the dispute. This information can serve as building blocks with which to create options the parties might not be able devise on their own because of their mutual distrust and reluctance to reveal pertinent information."[145]

Conclusions on Uses of ADR. There are a number of approaches to ADR which might help to reduce the time and expense of securities litigation. Any improvements to the efficiency of securities litigation would have obvious benefits to all parties in meritorious cases. Reduction in litigation expense should help to reduce the cost of capital and enhance the competitiveness of American companies in global markets, and more prompt resolution of claims should enhance investor confidence by providing faster recoveries when wrongdoing occurs. Currently, an average securities class action lawsuit lasts 3.9 years from commencement of the case to settlement. Moreover, the average class period in such cases is 2.3 years. This means that even in the average case, many investors do not receive compensation until more than six years after their investment.[146] The availability of ADR for prompt and inexpensive resolution of claims could also reduce any incentives that might exist to bring frivolous cases, and might help to resolve any frivolous or weak cases more expeditiously.

As the discussion above illustrates, there are a number of approaches to ADR which might be useful, depending on the facts, the legal issues, and the disposition of the parties in particular securities cases. It therefore may be inappropriate to mandate any particular type of ADR in all securities cases. A better approach would be to clarify the authority of courts to use non-binding ADR in appropriate cases, and to create incentives for parties to attempt to resolve disputes through ADR. This is consistent with the federal policy of empowering courts to find ways of improving the efficiency of the civil justice system, as reflected in the CJRA.

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[145] Ferrara & Ertel, supra note 136, at 83.

[146] See Steven P. Marino and Renee D. Marino, An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys or Underwriters, at 8-10 (accepted for publication at 22 Fed. Sec. L. J. 115 (summer 1994)(hereafter "Marino study").

3. Clarifying Liability in Fraud-on-the-Market Cases

As noted at page 6 above, in order to prevail on a private claim under Section 10(b) of the Exchange Act, a plaintiff, must show, inter alia, that the defendant reasonably relied on a material misstatement or omission by a defendant, that the defendant's conduct caused damages, and the extent of the damages caused. In Basic, Inc. v. Levinson[147] the Supreme Court indicated that in certain cases a plaintiff could establish reliance through what is known as the "fraud on the market theory." This theory holds that

> "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action."[148]

Although Basic accepted the fraud-on-the-market theory as a means of establishing reliance, it did not address whether proof of causation could also be met by the theory. The Supreme Court also declined to address how damages should be calculated in cases where the fraud-on-the-market theory applied. Few fraud-on-the-market cases have been tried to judgment. Consequently there is little decisional law concerning how damages should be calculated in fraud-on-the-market cases.

A number of companies have expressed concern that this lack of guidance puts them in a significant disadvantage in securities litigation. The general method of calculating damages in cases under Section 10(b) is the "out-of-pocket" measure. In the case of misleading disclosures affecting stock price over a period of time, this involves constructing a "price line" reflecting the impact of the misstatement on the daily market price and a "value line"

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[147] 485 U.S. 224 (1989).

[148] Basic, 485 U.S. at 247. The fraud-on-the-market theory is based on the "efficient market hypothesis" which holds that

> "in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers did not directly rely on the misstatements."

Id. at 241.

representing what the market price would have been if accurate information had been available to the market.Damage calculations in fraud-on-the-market cases are complex and unpredictable.[149] The range of damage estimates between experts retained by plaintiffs and those retained by defendants can be very substantial.[150] This uncertainty could put pressure on defendants to settle marginal cases.

A related concern about calculating damages is that any measure of damages which awards each plaintiff relying on the fraud on the market theory "out-of-pocket" damages fails to take into account that the losses incurred by the plaintiffs are offset by gains of investors on the other side of the trades. In other words, while some investors might lose as a result of a misleading disclosure, there is no net loss among all investors who were in the market while it was affected by incorrect information.[151] Consequently, in this view, basing damages on an "out-of-pocket" measure may be draconian, and may encourage companies to avoid any disclosure, rather than risk making disclosure which could be seen as excessively optimistic or pessimistic.[152]

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[149] Constructing the "value" line leads to vast complexities in many cases. See B. Cornell and R. G. Morgan, Using Finance Theory to Measure Damages in Fraud on the Market Cases, 37 UCLA Law Rev. 883 (1990) (hereafter "Cornell and Morgan").

[150] For example, in one case the court discredited plaintiffs' damage expert's estimate of total damages of $275.2 million, but also found that the defendants "failed to offer a substantial alternative analysis. In re Oracle Securities Litigation, No. C-90-0931-VRW (N.D. Cal. August 9, 1993) at 13. As another illustration, using the facts presented in Basic it is possible to argue that if the company had fully and timely disclosed the information that gave rise to the litigation (the existence of merger negotiations), the stock price could have ranged from $16.50 to $30. Cornell and Morgan, supra note 149, at 895-96.

[151] Easterbrook and Fischel, supra note 119, at 639-44. "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time. Such an investor perceives little good in a legal rule that forces his winning self to compensate his losing self over and over." Id. at 640-41.

[152] "The best rule might be a mechanical one -- say, one percent of the gross movement in the price of the firm's stock attributable to the wrong. This avoids the need to compute the real, and utterly unquantifiable, loss. Such a mechanical rule could be established only by statute, though, and we do not consider it further." Easterbrook and Fischel, supra note 119, at n. 44. Easterbrook and Fischel go on to note that the scienter requirement for anti-fraud actions might justify the use of an out-of-pocket measure of damages if the scienter standard effectively screens out marginal cases. "The more cases are filtered out, the more appropriate it is to use a multiplier in the remaining cases of

Causation. One approach might be to clarify whether the fraud-on-the-market theory can be used to establish causation as well as reliance. Even if the fraud-on-the-market theory is a reasonable means of establishing reliance, it is unclear that the theory should also be used to impute causation. There may be cases in which the plaintiff reasonably relied on the integrity of the market price, but the market price was not affected by the defendant's misrepresentation because other information in the market neutralized any impact which the misrepresentation might have had.[153] It may therefore be appropriate to require plaintiffs to provide proof in fraud-on-the-market cases that the alleged misrepresentation caused an effect on market price.

Damages. Unfortunately, there does not appear to be any way of formulating calculation of damages in fraud-on-the-market cases that would be easy to apply and appropriate to the facts of every case.[154] The only way of providing more certainty to potential damage exposure in such cases would be to place an upward limit on damages. For example, damages could be set at no more than the difference between market value at the time a misrepresentation was disseminated and the market value at the time corrective information was disseminated. For plaintiffs who sold their securities after the violation occurred, a cap could be set at the difference between market value at the time the misrepresentation was disseminated and the price at which plaintiff sold the security.

The drawback of placing such an upward limit on damage estimates is that it could reduce the amount of damages in some meritorious cases. Although plaintiffs appear rarely to recover most of their recoverable damages, a cap on damage liability might reduce recoveries to plaintiffs in some cases. However, there are many restrictions imposed on litigants which have the effect of reducing the liability of some wrongdoers, but which are nevertheless

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liability.... If the scienter rule does not filter out dubious cases, on the other hand -- if it turns out always to be possible to find some culpable omission when things go bad -- then loss-based damages are far too high, and it is necessary to put a more modest remedy in their place." Id. at 644.

[153] See Cornell and Morgan, supra note 149, at 913-16.

[154] "No formulaic approach provided by finance theory, or any other theory, can replace a detailed analysis of the facts." Cornell & Morgan, supra note 148, at 896.

adopted because of other policy concerns.[155] The policy consideration here is the need to provide more certainty to liability under the fraud-on-the-market theory. By providing such certainty, such upward limits on damages could reduce any leverage that a plaintiff with a weak case might have to extract a settlement based on a defendant's concern about a wide and unpredictable range of possible outcomes of the litigation.

Conclusions

The Subcommittee heard from a number of witnesses, in both the corporate and investor communities, who believed that there is an explosion of frivolous securities litigation. The empirical studies provided to the Subcommittee do not suggest any overall explosion of private securities litigation. However, the studies do not dispel concerns expressed about the extent of frivolous securities litigation. Much of the empirical evidence does suggest that factors other than the merits of each particular case may often affect the outcome of securities cases.

While the extent of frivolous litigation may be difficult to measure, it is also significant that participants in the capital markets, such as corporate issuers and institutional investors, are concerned about such abuses. ***That perception is likely to have a corrosive effect on investor confidence and to breed cynicism about the efficacy of private rights of action as a deterrent to wrongdoing***. Pages 45 to 59 above suggest several steps that could be taken to counter the concerns about frivolous litigation without limiting the ability of truly defrauded investors to pursue their legal remedies.[156]

As discussed in Appendix A, there does appear to be considerable evidence that securities class actions tend to settle for relatively small amount of potentially recoverable damages. ***Whether or not low settlement recoveries demonstrate an overabundance of frivolous cases, this pattern does call into question whether securities litigation that***

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[155] For example, statutes of limitations and the common law doctrine of laches are applied to virtually all civil actions even though they inevitably bar some legitimate claims.

[156] In addition to possible legislative or judicial action, one scholar suggests that the SEC could exercise rule-making authority under Section 10(b) to modify private rights of action. See Joseph A. Grundfest, Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 961 (1994).

routinely results in recoveries of pennies on the dollar is fulfilling any of the objectives of the federal securities laws. If investors routinely recover such small amounts regardless of the merits of any particular case, it is highly questionable whether private securities litigation provides any real confidence to investors that they are adequately protected from fraud. In addition, to the extent that securities litigation settlements merely entail payments from insurance companies, the securities litigation process seems to entirely bypass the deterrent function that is often cited as one of its primary purposes.[157]

[157] The recent decision of the Supreme Court in the Central Bank case that eliminated aiding and abetting liability under Section 10(b) of the Exchange Act, discussed at page 6 above, may also bear on the question of frivolous litigation. One possible consequence of the case may be that plaintiffs asserting 10(b) claims will pursue a broader range of defendants as primary violators. Some of those additional claims may be brought against professionals, such as accountants or lawyers, who assisted the violation but can no longer be pursued as secondary violators as a result of the Central Bank decision. In other instances, it may be difficult or impossible to make a claim against professionals as primary violators. In those circumstances, plaintiffs may find they have stronger incentives to assert weak claims against other "risk-averse" defendants whom they might not otherwise sue. For example, if plaintiffs are precluded from suing accountants or lawyers who may have assisted an alleged fraud, they may be more likely to assert weak claims against other parties, such as outside directors, in order to seek recovery out of those defendants' insurance coverage.

PART TWO -- CLASS ACTION ABUSES

Introduction

The importance of class actions in protecting small investors was explained in a noted court decision:

> "In our complex modern economic system where a single harmful act may result in damages to a great many people there is a particular need for the representative action as a device for vindicating claims which, taken individually , are too small to justify legal action but which are of significant size if taken as a group. In a situation where we depend on individual initiative, particularly the initiative of lawyers, for the assertion of rights, there must be a practical method for combining these small claims, and the representative action provides that method."[158]

Critics of securities litigation point to securities class actions as an area that is particularly prone to abuse. They argue that the class action system encourages "entrepreneurial" attorneys, who seek out cases in the hope that they can extract a settlement, regardless of merit, which will provide the attorneys with a generous fee. Settlements are skewed by distortions in the bargaining process.

In the hearings and in comments and articles submitted to the Subcommittee, three related criticisms emerged: (i) the allegiance of plaintiffs' counsel to their clients' best interests is questionable; (ii) plaintiffs' attorneys and defendants "collude" to construct settlements that ensure that plaintiff's counsel will be well paid and that settlement costs will come largely out of insurance coverage; and (iii) recoveries by plaintiffs in settlements are unrelated to the merits, and to the extent that they do reflect meritorious cases, they are inadequate to deter fraud or adequately compensate investors. For example, Judge Ralph Winter of the Second Circuit Court of Appeals recently wrote that:

> "class actions extract a deadweight loss from investors. In most such actions, the corporation receives no benefit but pays everyone's legal fees. In some cases, a benefit is received but is either paid from insurance that was purchased by the corporation or offset by indemnification. Because

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[158] Escott v. BarChris Construction Corp., 340 F.2d 731, 733 (2d Cir. 1965).

settlement is guided only in small part by the merits of the underlying claim, derivative and class actions result in the overcompensation of weak claims and the undercompensation of strong claims. Investors thus also lose because fiduciary or statutory obligations -- which I assume to be efficient -- are not effectively enforced."[159]

Operation of Class Actions in Securities Litigation In order for a case to proceed as a class action, the court must certify the class by finding that the requirements of Rule 23 of the Federal Rules of Civil Procedure have been met. Rule 23(a) requires that the court find (i) that the class is too numerous for all of its members to be joined as active parties in the case; (ii) there are questions of law or fact common to the entire class; (iii) the claims or defenses of the parties who seek to represent the class are typical of the claims or defenses of the entire class; and (iv) the representative parties will fairly and adequately represent the class.[160]

Following a ruling certifying a class, the court is generally required to provide notice of the pendency of the action, and to provide putative class members with an opportunity to exclude themselves ("opt out") from the

[159] Winter, Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America, 42 Duke L.J. 945, 952 (1993).

[160] In addition, the Court must find that at least one of the requirements of Rule 23(b) have been met. This requirement is generally met by Rule 23(b), which overlaps Rule 23(a) to some extent by requiring that "[q]uestions of law or fact common to the members of the class predominate over questions affecting only individual members," and "a class action is superior to other available methods for the fair and efficient adjudication of the controversy."

action.[161] In securities class action litigation, it is common for counsel for plaintiffs to advance the cost of this notice.[162]

Most securities class actions are settled.[163] Settlements require court approval and notice to members of the class, who may elect to opt out of the settlement and pursue individual claims. The court-approved notice to class members "must fairly apprise the prospective members of the class of the terms of the proposed settlement."[164] However, courts have generally not imposed strict requirements for the type of notice required, or the method by which notice is sent.[165]

In many instances, despite the direction of Rule 23(c)(1) that determination of class action status should be made "as soon as practicable after commencement" of the action, securities class actions are settled before the class has been certified. In those cases the court typically certifies the class as part of the settlement approval and distribution process. The notice will

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[161] Red. R. Civ. P. 23(c)(2), pertains to class actions maintained under Rule 23(b)(3), such as securities class action cases. 23(c)(2) provides that

> "the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude the member from the class if the member so requests by a specified date; (B) the judgement, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the member desires, enter an appearance through counsel."

[162] The named plaintiffs or their attorneys may be required to bear the cost of providing notice of pendency to the class. In Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974) the Supreme Court remanded a class action with instruction to dismiss because the plaintiff, whose individual stake in the case was only $70 and who sought certification of a class of 2,250,000 odd-lot traders, refused to pay for the notice.

[163] See Cooper Alexander, supra note 77, at 524-25, and authorities cited therein.

[164] Fed. R. Civ. P. 23(e).

[165] See, e.g., Weinberger v. Kendrick, 698 F.2d 61, 70 (2d Cir. 1982), cert. denied sub nom. Coyne v. Weinberger, 104 S.Ct. 77 (1983); In re Equity Funding Corp. of America Securities Litigation, 603 F.2d 1353, 1361 (9th Cir. 1979). In one instance the court approved notice of a settlement by publication on an inside page of the Christmas eve edition of the New York Law Journal. The notice gave objectors two days' notice and directed objectors to telephone the judge's chambers. See New York Law Journal, Dec. 24, 1985, at 20.

contain a description of the composition of the class and of the proposed settlement terms. This practice has the effect of bypassing any inquiry by the court into whether the requirements of Rule 23(a) and (b) have been met.[166] Cases resolved in this manner also may shift the cost of distributing notice of pendency from the named plaintiffs or their attorneys to the settlement fund.

Data on Securities Class Actions Since 1973, securities class actions have constituted approximately 10 per cent of all class actions filed. However, in 1992 securities class actions constituted over 30 per cent of all class actions then pending.[167] The total number of securities class actions has fluctuated greatly since numbers were first tracked in 1973. Between 1973 and 1978 the total number of such cases filed each year ranged from 167 to 305. Between 1979 and 1989 the total number of cases filed ranged from 86 to 151. Since 1989, the numbers have increased sharply, then declined somewhat, with 315 cases filed in 1990, 299 filed in 1991 and 268 filed in 1992.[168]

Even at these levels the total number of securities class actions filed constitutes only a few tenths of one per cent of all civil filings in district courts.[169] Moreover, these numbers do not reflect that multiple securities class actions may be filed against a single company arising out of a single

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[166] Some appellate courts have expressed concern about the possibility for abuse of this approach, but have stopped short of disapproving it. For example, Judge Friendly has observed:

> "Although we thus refuse to adopt a per se rule prohibiting approval when a class action settlement has been reached by means of settlement classes certified after the settlement, with notice simultaneous with that of the settlement we emphasize that we are permitting, not requiring, use of this procedure, and also underscore that ... district judges who decide to employ such a procedure are bound to scrutinize the fairness of the settlement agreement with even more than the usual care."

Weinberger v. Kendrick, supra note 161, at 73 (Friendly, J.).

[167] See letter from William S. Lerach to Senator Christopher J. Dodd from William S. Lerach, July 6, 1993, attachment at Table 1, Hearing Record at 800.

[168] McLucas statement, Appendix A, Hearing Record at 121.

[169] See McLucas statement, Appendix A, Hearing Record at 121 (setting out year-by-year numbers as reported by the Administrative Office of U.S. Courts for securities class action filings and for other securities filings and civil filings generally).

event, and later consolidated into one case.[170] According to James Newman, publisher of a newsletter on class action securities litigation, in 1989-92 the number of public companies sued was 112, 155, 127 and 113 respectively. Newman points out that the increase in securities filings reflects a tendency for several cases to be filed arising out of one event, and then consolidated by a court into one action. For example, in 1992 five companies were named in 74 lawsuits, most of which were later consolidated.[171]

Although the total number of securities class actions may be small, their economic impact may have significance well beyond the absolute number of cases. According to information provided by the American Business Conference, the American Electronics Association, the AICPA, the Association of Publicly Traded Companies and the National Venture Capital Association, securities class actions filed in 1992 sought a total of $10.7 billion on behalf of 735,000 claimants, and total securities class actions pending in 1992 sought a total of $25.7 billion on behalf of 1,760,000 claimants.[172]

A. Evidence Concerning Class Action Abuses

1. Illustration of Securities Class Action

In his testimony before the Subcommittee, William S. Lerach cited In re Public Service Co. of New Mexico as an illustration of the essential role that private actions play in supplementing government enforcement of the securities laws.[173] That litigation may therefore be a suitable "case study" of securities class action litigation.

Between April 18, 1989 and July 26, 1991, five securities fraud actions were filed in federal district courts in New Mexico and California, and in New

[170] For example, according to Securities Class Action Alert, in 1992 20 class action suits were filed against one company. See letter from James M. Newman, Publisher, Securities Class Action Alert, to Senate Subcommittee on Securities, June 15, 1993.

[171] Statement of James M. Newman, Hearing Record at 777, 780.

[172] Letter from Barry Rogstad, John Mancini, Jake Netterville, Brian T. Borders and Mark Heeson to Senator Christopher J. Dodd , July 22, 1993, at Exhibit B, Hearing Record at 726. It is unclear whether this amount is adjusted to eliminate the double-counting problem pointed out by Mr. Newman.

[173] Lerach statement, Hearing Record at 145.

Mexico state court. Each of the cases was filed as a class action, and named the Public Service Company of New Mexico ("PNM") and several of its officers and directors as defendants. The classes in the various cases were alleged to consist of (i) all PNM shareholders between September 24, 1986 and January 31, 1991 and (ii) New Mexico residents who bought PNM stock between October 1, 1985 and September 24, 1986). In addition, four state law "derivative actions" were filed during that same period in state and federal courts in New Mexico. Following commencement of the litigation, all of the various actions filed against PNM were consolidated into one case in the U.S. district court for the Southern District of California.[174]

Some of the securities cases filed against PNM alleged that officers and directors of PNM manipulated the price of PNM stock by inflating the value of unregulated subsidiaries of PNM which were obtained under a company diversification plan. The other securities cases claimed that PNM misrepresented and omitted certain facts concerning excess electric generating capacity and failed to write down assets associated with the diversification efforts. In addition, a group of cases asserted state law claims on behalf of PNM against former officers and directors of PNM based on the theory that those officials wasted PNM assets in the diversification campaign. PNM appointed a special committee to investigate these claims. After a 16-month campaign, the committee determined that there was some basis to this claim, and estimated that damages associated with the state law claims were in excess of $200 million.[175]

Following extensive discovery of both the state law and federal securities law claims, the parties entered into a tentative settlement agreement in the late spring of 1992 under which PNM and its insurers would pay $33 million to settle the claims. On May 7, 1992, the Court gave preliminary approval to the settlement proposal and certified a class for purposes of the settlement consisting of all purchasers of PNM stock from October 1, 1985 through

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[174] See Memorandum Decision Findings of Fact and Conclusions of Law Award of Attorneys' Fees and Expenses and Order Thereon (hereafter "Memorandum Decision"), In re Public Service Company of New Mexico, Civ. No. 91-0536M (S.D. Cal. July 28, 1992), at 1-2.

[175] Memorandum Decision at 3-5.

January 31, 1991. The court scheduled a hearing on final approval of the settlement for June 29, 1992.[176]

On May 9, 1992 notice of the class certification and proof of claim forms were mailed to approximately 274,000 current and former PNM shareholders who were believed to be class members. In addition, the notice was published in local and national newspapers.

The notice to class members described the allegations against PNM as follows:

> "The PNM Class Actions allege, among other things, that Defendants made material misrepresentations and failed to disclose material information relating to PNM's diversified business enterprises and PNM's utility business. The PNM Class Actions allege, among other things, that Defendants failed to disclose serious problems that PNM was experiencing with regard to its diversified business enterprises and with regard to PNM's uncommitted or excess utility capacity."[177]

The notice also stated that "PNM and the Individual Defendants have denied the material allegations made in the PNM Class Actions and the Derivative Actions and have denied any liability or wrongdoing whatsoever to the Plaintiffs or to the Class."[178]

According to the notice, the parties decided to settle the actions because

> "[plaintiffs] have evaluated the expense and length of time necessary to prosecute the PNM Class Actions through trial, taking into account the uncertainties of predicting the outcome of complex litigation. Based upon consideration of all of these factors, Plaintiffs and their counsel have concluded that it is in the interest of Plaintiffs and the Class Members to settle the PNM Class Actions with [the defendants]...."[179]

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[176] Notice of Pendency of Class Action, Proposed Settlement of Class Action and Settlement Hearing at 1.

[177] Id. at 2, ¶ 4.

[178] Id. at 2, ¶6.

[179] Id. at 2, ¶ 8.

"PNM and the Individual Defendants deny any liability to the Class Members and maintain their innocence of any fault or wrongdoing. Nevertheless, since a settlement would minimize further burden and expense to PNM and the Individual Defendants, dispose of the PNM Class Actions as to them and avoid further distraction and diversion of them and their business and personnel. PNM and the Individual Defendants consider it desirable to settle the PNM Class Actions on the terms set forth in the Stipulation."[180]

Although the notice made general reference to "extensive discovery," including "an analysis of hundreds of thousands of pages of documents, the taking of testimony of dozens of depositions, and the engagement of experts to analyze various issues,"[181] it made no reference to any facts which could help class members to evaluate whether the plaintiffs' allegations or the defendants' continuing assertions of innocence had merit. Nor did the notice provide any method for class members to obtain further information about what was learned from this extensive discovery.

The notice indicated that a $33 million settlement fund had been established by the defendants' insurers. It also explained that $3 million of that amount would be reimbursed to PNM to partially compensate for its legal expenses, and that an undetermined additional amount could be deducted for plaintiffs' attorneys' fees and fund administration costs. The notice indicated that investors who wished to participate in the class action could file a proof of claim, and that they would be paid pro rata from the balance of the settlement fund, based on the market loss which they sustained on their shares.[182]

The court approved the settlement on July 28, 1992. The court expressed strong support for the outcome achieved:

"The settlement achieved is outstanding. Unlike many situations where a company has undergone costly and extensive litigation, PNM has survived and is continuing to provide a valuable service to the people of New Mexico, and it is being prudently and effectively managed. This

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[180] Id. at 2, ¶ 10.

[181] Id. at 2, ¶ 9.

[182] Id. at 2, ¶ 7, 3, ¶21 (b) and (c).

litigation had the potential to be so destructive from a financial standpoint that the company might have ceased to operate. This would have sorely disappointed the shareholders and deprived the people of New Mexico of a valuable service. The shareholders are directly benefitted by the preservation of their company. Due to the combined efforts of all persons involved, the litigation has ended in a manner that benefits both the current and past shareholders of PNM."[183]

Counsel for plaintiffs sought a total of $16.1 million in attorneys' fees and $1.5 million in expenses from the settlement fund. The court praised the work done by plaintiffs' counsel but stated that it was "deeply troubled by the magnitude of the request" for expenses such as hotels, meals, travel and payments to experts. The court awarded $10.5 million in expenses and $1.1 million in costs out of the settlement fund.[184] As a result of the settlement, a total of $332 million in claims were filed by class members. Of this amount, most of the class members received a payment of 6.51 per cent of their allowed claims from the settlement fund.[185]

Observations About Illustrative Case Although Mr. Lerach was correct that the court in In re Public Service Company of New Mexico highly praised the work of plaintiffs' counsel, this example of successful securities class action litigation raises several troubling questions. First, it is unclear whether this case achieved any of the policy objectives of private securities litigation. It is difficult to identify any deterrent effect that the case might have had. There was no admission or finding that the defendants violated the federal securities laws.[186] The entire amount of the settlement fund was paid by insurers, and no other legal sanction was visited on the defendants as a result of their alleged wrongdoing. It is also difficult to assert that the case served the

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[183] Memorandum Decision, supra note 174, at 5-6.

[184] Id. at 25-26, 28. In addition, the court awarded $419,000 out of the settlement fund to the claims administrator for the costs of distributing class notice and administering the fund. See Item 192, October 26, 1993, Civil Docket Sheet, Civ. No. 91-CV-536.

[185] First Order Distributing Settlement Funds to the Plaintiff Class, In re Public Service Company of New Mexico, Civ. No. 91-0536M (S.D. Cal. September 28, 1993), at 2.

[186] The internal PNM committee report described at page 66 above apparently suggested that some former officials of PNM might have violated fiduciary duties to the company. However, this would not necesssarily be tantamount to a violation of the federal securities laws.

interest of providing compensation to defrauded investors. Assuming that there was a violation of the federal securities laws, the class members recovered less than 7 per cent of their allowed losses.

A second aspect of the case that appears somewhat troubling is the way class certification and notice were handled. Although Rule 23(c) directs courts to determine whether a class action should be maintained "[a]s soon as practicable after the commencement of an action brought as a class action," the court did not certify the class in this case until more than a year after the first class action was filed, and after many millions of dollars in attorneys' fees had been expended in discovery. In addition, the notice provided to class members about the case and the proposed settlement provided little if any information from which they could judge whether the case had merit. The notice also provided no meaningful information to investors about what the likely amount of their claims would be so that they could consider whether the offered settlement amount was acceptable to them.

In sum, if one assumes that this case is fairly representative of the way securities class action litigation functions,[187] it raises serious questions about the extent to which this type of litigation serves the policy objectives of the federal securities laws. In order to determine whether these concerns are legitimate, it is necessary to consider testimony and other evidence provided to the Subcommittee.

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[187] A recent example has come to the attention of the Subcommittee staff which may raise similar questions. In In re Pacific Enterprises Securities Litigation, a pending securities class action, counsel for plaintiffs and defendants have filed a settlement proposal with the court under which plaintiffs' counsel would receive up to $19 million of a $45 million settlement. The proposed settlement would dispose of the case in two steps: (i) federal securities law claims would be resolved by payment of $33 million, and plaintiffs' counsel would apply to the Court for a fee award of up to one-third of that amount; and (ii) pendent state law claims would be settled by a payment of $12 million, of which $8 million would be paid to plaintiffs' counsel. See Stipulation of Agreement re Class Action Claims at 31; Stipulation of Agreement re Derivative Claims at 16-18, In re Pacific Enterprises Securities Litigation, (No. CV-92-0841-JSL)(C.D. Cal. (Jan. 25, 1994). The notice sent to class members does not disclose this $8 million payment. See Notice of Pendency and Settlement of Class Action, Exhibit A-1 to Stipulation of Agreement re Class Action Claims. According to an attorney separately retained by plaintiffs, potential damages in the case could be over $1 billion. See letter from Andrew Kahn to George Kramer, March 7, 1994, at 2.

2. Evidence Concerning Protection of Investors.

The most vocal critic of securities class actions at the Subcommittee's hearings was Patricia Reilly, a securities investor who had been a class member in two securities class actions, and who on both occasions flew at her own expense to the court's settlement conference to object to the amount of attorney's fees awards. Reilly stated that in one of the cases in which she was involved, attorneys for the plaintiff class received $3,300,000 in legal fees out of a settlement fund of $9,125,000, but investors only recovered 17 per cent of their losses. In the other case, out of a settlement fund of $30,000,000, plaintiffs' counsel was awarded $7,845,000, although investors would recover less than 5 per cent of their losses. Reilly also noted that both settlements were funded entirely out of insurance proceeds, with no money coming from the individual officers or directors alleged to have committed fraud.

Based on her experience, Reilly testified that class action settlement procedures did not adequately inform investors about the terms of proposed settlements, especially the percentage of investor losses that would be recovered and the amount of attorneys' fees to be received by class counsel. She believed that in practice, securities class action litigation tended to benefit plaintiffs' lawyers without a concomitant benefit to class members. She proposed that shareholders' lawyers fees should be more closely linked to the amount that investors recover of their losses.[188]

Reilly also noted that both of the cases in which she was involved as a plaintiff settled within the defendants' insurance coverage. She argued that the deterrent purpose of the securities laws was lost in the cases in which she was involved. "As the system is presently set up, the victims, the stockholders who lost their money through fraud are not compensated, and the offenders who caused the losses are not held accountable. The suits are really brought so that the shareholders' lawyers can suck money out of insurance companies."[189]

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[188] Prepared statement of Patricia Reilly, Hearing Record at 136-38.

[189] Id. at 139. Reilly made several suggestions based on her experience as a class member. First, she suggested that the settlement process should be reformed in several respects. She suggested that the claim form sent to class members should take into account the distinction between market losses and recoverable damages by including a formula for each investor to use to calculate the amount of market loss caused by fraud, and that settlement distributions should be based on recoverable damages for each investor, rather than market loss. Second, notices of settlement should explain the

Ms. Reilly's testimony was challenged in several respects by William S. Lerach. He noted that in one of the cases described by her, the court responded to Ms. Reilly's objections by noting that the settlement was the only alternative to pushing the company into bankruptcy. The court went on to state that "'under the difficult circumstances, where you're facing the choice between putting somebody in bankruptcy and losing everything or taking what you can get and getting something out of it... [that it] was very commendable to be able to settle the case and bring it to this conclusion within this period [of] time.'"[190] Mr. Lerach pointed out that although there were class members with much larger stakes in the outcome, only Ms. Reilly came forward to object to the settlements in these two cases.[191]

Ralph Witworth, the President of United Shareholders Association, also expressed concern about the effectiveness of securities class actions in providing meaningful recoveries to investors:

> "The winners in these suits are invariably lawyers who collect huge contingency fees, professional 'plaintiffs' who collect bonuses and, in cases where fraud has been committed, executives and board members who use corporate funds and corporate owned insurance policies to escape personal liability. The one constant is that the shareholders pay for it all. In fact, in many cases shareholders get hit twice -- once with the original fraud and then again in the so-called settlement where legal fees soak up forty percent or more of the proceeds. Even when pennies on the dollar do trickle down to the shareholders, to the extent that they still own stock in the company, they are literally being paid with their own

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percentage of recoverable damages covered by the settlement fund so that investors can make a more informed decision about whether to opt out of the settlement. Third, settlement notices should explain any conflict of interest between the class counsel recommending the settlement and class members, and should advise shareholders of the possibility of a larger recovery if they choose to litigate. Fourth, settlement notices should break out legal fee requests to show details such as the hourly rate, total hours expended and number of attorneys working on the case. Fifth, lawyers should receive their fee award at the same time that shareholders receive their distributions from the settlement fund. Letter from Patricia Reilly to Senator Christopher J. Dodd, July 11, 1993, at 18.

[190] Letter from William S. Lerach to Senator Christopher J. Dodd, July 16, 1993, Hearing Record at 807-08 (quoting record from settlement hearing in Tucson Electric case).

[191] Id. at 188.

money, either through direct payments from the corporation or in the form of higher insurance premiums."[192]

The State of Wisconsin Investment Board ("SWIB") wrote to the Subcommittee to express its support for reforms of securities class action litigation. SWIB is one of the ten largest public pension funds in the United States, with $33 billion under management. SWIB noted that in the last three years it has recovered $7 million as plaintiffs in 30 securities class actions. Nevertheless, SWIB observed that the current system puts plaintiff's attorneys "in the drivers seat" because it

> "gives plaintiffs' attorneys a far greater interest in shareholder class actions than any of the plaintiffs they represent. This creates an inherent conflict of interest, encouraging attorneys to file and settle cases at a point where their ability to recover the highest fee per unit of time spent on a case is maximized, provided a reasonable recovery is obtained for the plaintiff shareholders."[193]

According to SWIB,

> "[t]he flaws in the current system include:
>
> (a) Attorney fees and costs consistently take the lion's share of recoveries in situations where plaintiffs go largely uncompensated for their losses.
>
> (b) There is typically no plaintiff with a large enough interest to provide the guidance of a real client and counterbalance the interests of plaintiffs' counsel. This makes it difficult to determine whether cases are being brought by plaintiffs with a substantial, real interest and whether cases are being settled at levels far below their real value."[194]

3. Evidence Concerning Role of Plaintiffs' Counsel

One widespread criticism of class action securities litigation is that plaintiffs' attorneys "sell out" their clients for a relatively small recovery which

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[192] Witworth statement, Hearing Record at 364.

[193] SWIB letter, supra not 70, at 2.

[194] Id.

includes a generous fee award. As discussed at pages 29-32 above, the balance of the evidence concerning the amounts of legally recoverable damages that investors recover suggests that investors typically recover only a small portion of their legally recoverable damages. Low recovery rates may suggest that the class action system produces results that are inadequate to deter fraud or adequately compensate investors in cases in which fraud actually occurred.[195]

Mr. Lerach defended the role of plaintiffs' counsel in the securities class action system as it currently functions. He pointed to a study which indicated that attorneys' fees in a survey of 334 securities class action cases found that fees and costs received by plaintiffs' counsel on average were 15.2 per cent of the recovery.[196] He also cited what he described as "substantial procedural safeguards" controlling the award of attorneys' fees in securities class actions:

"• Fees are paid only out of the recovery. If there is no recovery, the attorney gets no fee.

• Plaintiffs' counsel must advance the costs -- which can be very substantial -- to fund the prosecution of the case. Class members are not required to put up any money.

• No fee or expense reimbursement can be awarded without notice to the class of the amount sought and a hearing at which they can object in writing or in person.

• As many class members are institutional investors with large claims, i.e., a significant stake, who are repeat claimants, they have a real incentive to monitor this process and participate.

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[195] Somewhat ironically, those who advocate curtailing the current litigation system point to statistics showing that investors recover very small percentages of their losses, while those who defend the current liability scheme (or favor making it more expansive) offer numbers showing much higher amounts of recovery.

[196] See Lerach statement, Hearing Record at 144. However, plaintiffs' attorneys often seek much higher fees. For example, in one pending case involving federal securities and pendent state law claims, class plaintiffs' counsel seeks up to $19 million, or 42 per cent, from a $45 million settlement with defendants. See note 187, supra.

- No fee or expense reimbursement can be made except by the federal judge who has overseen and managed the litigation."[197]

Others were more critical of the role of plaintiffs' counsel in class action cases. The SEC observed in its testimony to the Subcommittee that "a class action counsel tends to operate in an entrepreneurial capacity rather than as a fiduciary operating at the direction of a client."[198] Much academic discussion echoes the SEC's observation about the "entrepreneurial" nature of class action counsel. There is widespread agreement among legal scholars that plaintiffs' counsel does not fit into the traditional image of the lawyer as an independent professional acting as an agent of a client and subject to his client's control.[199]

> "Even the most practical litigator or judge is often the slave of some defunct law professor who taught him to think of the lawyer as a fiduciary. Convenient and comforting as it is to view the attorney only through this nostalgic lens of fiduciary analysis, a fixation on this mode of analysis is likely to blind us to the real issues relating to the incentives and misincentives that the law today creates for the plaintiff's attorney."[200]

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[197] Response to Written Questions of Senator Sasser from William S. Lerach, Hearing Record at 273.

[198] McLucas statement, Hearing Record at 117. One illustration of this may have occurred in connection with the SEC's settlement with Prudential Securities, Inc., described at page 51 above. According to a recent news report, the SEC and state regulators are deeply concerned about a $27 million fee application made by plaintiffs' counsel in a $90 million class action settlement with Prudential. According to this report, the plaintiffs' attorneys earlier supported a $37 million settlement offer by Prudential. That offer was subsequently substantially increased as a result of enforcement efforts by state and federal regulators. According to one California official quoted in the article, the plaintiff's attorneys "made little, if any, real contribution to the substantial increase in the settlement." SEC Is Reviewing Legal Fees Requested in Prudential Securities Class Action, Wall St. J., Feb. 14, 1994, at A4

[199] See Jonathan R. Macey and Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. of Chicago L. Rev. 1, 3 (1991) (hereafter "Macey and Miller"); Coffee, supra note 75; Kenneth W. Damm, Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest, 4 J. Legal Stud. 47, 60 (1975).

[200] Coffee, supra note 75, at 727.

In the view of these scholars, confusion about the nature of plaintiff's counsel hampers the effectiveness of procedural safeguards intended to protect class members.[201] "Because these attorneys are not subject to monitoring by their putative clients, they operate largely according to their own self-interest, subject only to whatever constraints might be imposed by bar discipline, judicial oversight, and their own sense of ethics and fiduciary responsibilities."[202]

These critics of securities class action have expressed particular concern about the role of class counsel in settlements.

> "[T]here are three sets of interests involved in these actions: those of the defendants, the plaintiffs, and the plaintiffs' attorneys. Often, the plaintiffs' attorneys and the defendants can settle on a basis that is adverse to the interests of the plaintiffs. At its worst, the settlement process may amount to a covert exchange of a cheap settlement for a high award of attorneys' fees."[203]

This danger also may be a factor in the debate over frivolous litigation.

> "Once polite collusion becomes possible in this manner, it affects the quality of the cases that plaintiff's attorneys will bring in the long run. Plaintiff's attorneys have less reason to screen their cases and may bring

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> "The existing regulations are extraordinarily ineffective at aligning the interests of attorney and client; indeed, they often impair the interests of the clients they are ostensibly designed to protect. Many regulatory shortfalls can be traced ultimately to a single fundamental error: the inappropriate attempt to treat entrepreneurial litigation as if it were essentially the same as standard litigation, in which the client exercises substantial influence. Even when the regulatory system acknowledges that entrepreneurial litigation poses special problems, it frequently attempts to resolve those problems by forcing class action and derivative litigation back into a standard model."

Macey and Miller, supra note 199, at 3-4.

202 Id. at 8.

203 Coffee, supra note 75, at 714.

weak cases whose settlement value, when based simply on the litigation odds, would not normally cover the attorneys' opportunity costs."[204]

Despite the safeguard of court review of class action settlement terms, this danger may be also be exacerbated by the general judicial policy favoring settlement. As one district judge stated, "[i]n deciding whether to approve this settlement proposal, the court starts from the familiar axiom that a bad settlement is almost always better than a good trial."[205]

4. Role of Insurance Coverage

Another criticism of class action securities litigation is that insurance coverage of the defendants covers the bulk of any settlement, undermining the deterrent impact of meritorious securities cases. As noted at page 29 above, a number of witnesses who testified suggested that insurance coverage was a driving force behind many cases. Melvyn Weiss also provided information to the Subcommittee on settlements achieved in 66 cases, which revealed that insurance carriers provided all or most of the payment for one or more settling defendants in at least 40 cases.[206] In at least nine of those cases, insurance carriers paid the entire amount of the settlement, including one case in which a case was settled for a $29 million payment by an insurance carrier, with the company and its officers and directors paying nothing.

According to Professor Cooper Alexander and others, director and officer insurance policies are available in approximately 80 per cent of shareholder litigation, and provide 50 to 80 per cent of the settlement amounts in such cases.

> "Because the money insurance carriers contribute does not come directly out of the pocket of any party, both sides regard it as an independent source of funds and place a high value on preserving access to it. Insurance and (for the individual defendants) indemnification by the corporation are also important to defendants as a way of shifting their

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[204] Id. at 718.

[205] In re Warner Communications Securities Litigation, 618 F. Supp. 735, 740 (S.D.N.Y. 1985).

[206] Weiss letter, supra note 56, at Exhibit 3.

legal costs to others. Both of these important sources of recovery are available to fund a settlement, but <u>not</u> to pay a judgement."[207]

Professor Coffee has analyzed the impact of insurance coverage in a specific case:

> "During a critical period just prior to the delayed [adverse] announcement of its third quarter earnings, 13 Warner executives sold significant portions of their personal holdings in the company.... This pattern obviously suggested insider trading. Class and derivative actions were eventually brought in Delaware and the Southern District of New York against Warner for 'fraud on the market,' and against the individual defendants for insider trading. A fund of $17,500,000 was eventually negotiated to settle both the state and federal claims.... The individual defendants contributed $2,000,000 in the state proceeding, while the insurance carrier on the policy covering both the defendants and Warner paid $6,000,000; the balance of roughly $9,500,000 was paid by Warner. Because the premiums on director and officer insurance are invariably paid by the corporation (and increase after such a settlement), one can view this settlement as one in which the individual defendants contributed less than 12 per cent of the total fund and did not disgorge their full insider trading gains.... Nonetheless, the parties most responsible for the violation of Rule 10b-5 (and the only parties able to profit from the entire set of events) still profited and escaped the bulk of the financial sanction. The lesson... may be that insider trading remains profitable so long as the insiders can transfer their liability to the corporation on the theory that the corporation misinformed the market."[208]

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[207] Cooper Alexander, <u>supra</u> note 77, at 550. Notwithstanding this observation, Professor Cooper Alexander rejects the solution of simply eliminating insurance coverage for securities fraud claims. She noted reports that directors have resigned when companies dropped their director and officer policies, and that outside directors would be the most deterred. "The proposal would therefore runs contrary to current trends in corporate governance thinking, which favor increasing the role of outside directors." <u>Id</u>. at 584. Moreover, Cooper Alexander suggested that abolishing insurance coverage might not greatly weaken incentives to bring weak suits, since directors and officers in many instances could still seek indemnification from the company, and plaintiffs might simply expand the group of defendants to bring in more potential pockets of recovery. <u>Id</u>.

[208] Coffee, <u>supra</u> note 75, at 719, fn. 134 (discussing <u>In re Warner Communications Sec. Litig.</u>, 618 F. Supp. 735 (S.D.N.Y. 1985).

5. **Disbursal of Unclaimed Funds**

The Subcommittee has learned of recent reports raising concerns about the disposition of unclaimed class action settlement funds. Two separate issues have been identified. First, defendants and plaintiffs' counsel have structured a type of settlement, known as a "claims-made" settlement, which provides for the return of any funds unclaimed by class members to the defendants. Second, the Subcommittee has received information that in some cases unclaimed settlement funds may be disbursed to entities favored by either plaintiffs' counsel or defendants. Both of these phenomena raise additional questions about the potential for collusion between plaintiffs' counsel and defendants to the detriment of class members.

"Claims-Made" Settlements. In recent years, settlement agreements in some securities class action cases have been structured to provide that plaintiffs' counsel's fee award will be calculated out of the amount initially paid into the settlement fund by defendants, but defendants will receive back any amount not paid out to class members. In addition, these agreements often provide a maximum percentage that each class member will receive of its provable claims. The effect of this structure may be to make plaintiffs' counsel economically indifferent to the amount actually recovered by investors, while creating incentives for defendants to challenge investors' claims on the fund.

To illustrate, in one recent "claims-made" class action settlement approved by a court, the defendants agreed to pay $42 million into a common fund and the parties agreed that plaintiffs' counsel would receive a $14.2 million fee award out of the fund. However, the agreement stipulated that class members could only recover 10 per cent of their claims. If class members made claims totalling $425 million (the maximum damages alleged under plaintiffs' damage calculation) they would receive 10 per cent of their claims (6 per cent after deducting attorneys' fees and expenses).[209]

This structure poses a number of problems for investors. The defendants have a financial incentive to challenge particular claims, since each dollar in claims rejected by the claims administrator goes directly back to the defendants. The ethical obligation of the lawyers for the claimants to fight to maximize the amount of claims diverges from their economic incentives, since the amount of their payment is already fixed regardless of how many claims are accepted. Moreover, many class members may have little incentive to

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[209] In re Crazy Eddie Securities Litigation, 824 F.Supp. 320 (E.D.N.Y. 1993).

pursue their claims in light of the fractional amount of the recovery. Consequently, this type of settlement may further skew the securities class action system in the direction of dividing the loyalty of plaintiffs' attorneys from their clients.[210]

Disbursal of Funds to Third Parties. The Subcommittee has also heard reports that in at least two instances undistributed funds in securities class action settlements were distributed to third parties. In one instance, the court approved a proposal to use the unclaimed portion of the settlement fund to establish a $546,000 law professorship, and to donate an additional $100,000 to the alma mater of the named plaintiff.[211] In another recent case, the court approved a settlement which provided that the unclaimed portion of the settlement fund would be distributed to a municipal legal aid organization.[212] There have also been reports that unclaimed settlement funds in class action cases outside the securities law context have been disbursed to third parties, such as the Consumers Union and other consumer advocacy groups, as well as eleemosynary organizations.[213]

These disbursals appear to be an extension of the cy pres doctrine.

> "Historically, the cy pres concept was fairly limited and restricted to the closest comparable alternative to the original purpose for which the funds in question had been designated. The trust would fail unless the dominant purpose could be carried out, but incidental requirements that

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[210] For a detailed discussion of this issue, see John C. Coffee, Jr., Claims Made Settlement: An Ethical Critique, New York Law Journal, July 15, 1993 at 5. Coffee notes that claims-made settlements may be appropriate in some circumstances. "Some fact patterns may justify their cautious use, subject to close judicial scrutiny. One such instance arises when the extent of the investor losses are not easily ascertainable because, for example, the transactions occurred outside of the context of public securities markets." Id.

[211] See Securities Class Action Alert, July 1991, at 70-71.

[212] In re Dime Savings Bank of New York, FSB, reported in Securities Class Action Alert, January 1994, at 24-25.

[213] See Schmitt, Consumer Groups Reap Windfall on Suits, Wall St.J., April 22, 1994, at B-3.

became impossible or impracticable could be avoided only through the application of cy pres."[214]

It is unclear whether the distribution of unclaimed securities settlement funds to third parties raises the same potential for collusion against investors as the claims-made settlement process described above. Nevertheless, this trend poses the question whether it is appropriate for securities class action settlements to serve as ancillary vehicles for the political or social goals of defendants or plaintiffs' counsel unrelated to the interests of class members. The handling of unclaimed securities class action settlement funds deserves more attention from courts and policy makers.

B. Suggestions for Reform

1. Reforming Class Counsel Fee Awards.

Judges and academic observers have criticized the widespread judicial practice of permitting fee awards to plaintiffs' counsel based on hourly billing rather than a percentage of the recovery. In securities class action settlements, as in other common fund cases in which the plaintiffs' attorney generates a fund for the benefit of the class, most courts award fees based on the "lodestar" approach. Under this approach, the court determines a lodestar amount by multiplying the attorney's hours expended by a reasonable hourly fee. The lodestar may then be enhanced by a multiplier to reflect factors such as the risk of the litigation.[215]

Although fee awards under the lodestar approach are subject to judicial review, many observers believe that the system creates an unwarranted incentive for attorneys to expend hours unproductively or inefficiently in order to obtain a larger fee. There has been speculation that plaintiffs' attorneys may guarantee substantial fees by reaching an understanding with defense counsel early in litigation about the general terms of a settlement, and then spending a mutually agreeable amount of time litigating the case before

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[214] Superior Beverage Co. v. Owens-Illinois, Inc., 827 F. Supp. 477, 478 (N.D. Ill. 1993). The court went on to note that the doctrine had become more flexible, and had been used to distribute funds in antitrust settlements to law schools and advocacy organizations.

[215] See Lindy Bros. Builders v. American Radiator & Standard Sanitary Corp., 487 F.2d 161 (3d Cir. 1973); Robert T. Mowrey, Attorney Fees in Securities Class Action and Derivative Suits, 3 J. Corp. L. 267, 334-48 (1978).

finalizing the settlement, with the additional hours charged against the settlement fund.[216] The lodestar approach has also been criticized by both judges and scholars because it may be cumbersome for judges or class members to effectively audit the hours expended by class counsel.[217]

Many of these critics have suggested that a percentage-of-recovery fee award is preferable to the lodestar approach.[218] This method has become popular with many courts in recent years in securities class actions and other common fund cases.[219] Its chief advantage is that it is easy to calculate. In addition, it aligns the interest of plaintiffs' counsel more closely with the

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[216] Macey and Miller, supra note 199, at 22-23.

[217] "Judges rarely reject fee petitions presented as part of a settlement. If they reject a fee settlement, they may find themselves wading through affidavits and time sheets in an effort to determine the appropriate fee themselves, something most trial judges would prefer to avoid." Macey and Miller, supra note 199, at 48. See also In re Continental Illinois Securities Litigation, 750 F. Supp. 868, 878 (N.D. Ill. 1990)(in decision cutting fee request, court noted that "I have examined each of the hundreds of pages of time entries submitted in support of the 41,955 hours of attorney and paralegal time claimed in the petition. I have also examined the 16-volume set of appendices containing copies of every pleading or memorandum on which more than 20 hours of time was spent. It may be that only an exercise of this kind can convince one of the futility of attempting to decide what amount of time was necessarily spent on a case of this breadth and duration.").

[218] Notably, the Third Circuit, which was the first to adopt the lodestar approach in common fund cases in Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp., 487 F.2d 161 (3d Cir. 1973), appointed a task force of judges and lawyers to study problems with attorney fee awards. The task force recommended that the lodestar approach be abandoned, and replaced by a percentage fee arrangement, to be determined at "the earliest practical moment." The task force also recommended that the fee should be based on a sliding scale, with the percentage decreasing as the size of the fund increases, and that in order to promote early settlement, the fee could provide for a premium incentive based on how quickly or efficiently the matter was settled. See Report of the Third Circuit Task Force, Court Awarded Attorneys' Fees, 108 F.R.D. 237 (1985) (hereafter "Third Circuit Task Force Report"). See also Macey and Miller, supra note 195 at 59-60; Coffee, supra note 75 at 724-25.

[219] See Third Circuit Task Force Report, supra note 218, at 246-49 (1986). At least two circuits mandate the use of the percentage-of-recovery approach. See Swedish Hospital Corporation v. Shalala, 1 F.3d 1261 (D.C. Cir. 1993); Camden I Condominium Association, Inc. v. Dunkle, 946 F.2d 768, 774 (11th Cir.1991). Other circuits permit either approach: see Florida v. Dunne, 915 F.2d 542, 545 (9th Cir. 1990); Brown v. Phillips Petroleum Co., 838 F.2d 451, 454-56 (10th Cir. 1988); In re "Agent Orange" Products Liability Litigation, 818 F.2d 226, 232 (2d Cir. 1987).

interest of class members in maximizing their recovery. Consequently, it relies on incentives, rather than increased judicial monitoring, to ensure that class members interests are represented in settlements. For example, in rejecting the use of the lodestar method in common fund cases, the Court of Appeals for the District of Columbia recently stated:

> "[U]sing the lodestar approach in common fund cases encourages significant elements of inefficiency. First, attorneys are given incentive to spend as many hours as possible, billable to a firm's most expensive attorneys. Second, there is a strong incentive against early settlement, since attorneys will earn more the longer a litigation lasts....
>
> "In the common fund case, by contrast, victory is still the key factor, but, as in the present case, the monetary amount of the victory is often the true measure of success, and therefore it is most efficient that it influence the fee award. That is, in the common fund case, if a percentage-of-the-fund calculation controls, inefficiently expended hours only serve to reduce the per hour compensation of the attorney expending them. On the other hand, if we apply the lodestar method to the common fund case, then the attorney inefficiently expending an excess amount of time does stand to gain by that inefficiency if the awarding court does not ultimately recognize the inefficiency in the far from exact testing of the fee award hearing. The danger that the court will not recognize unreasonably expended hours is magnified by the fact that in the common fund case the only party having an adverse interest at the time of the award will be the attorney's own clients, often a diverse and scattered group with small individual stakes."[220]

One innovation on the percentage-of-recovery approach was a competitive bidding approach recently used by a federal court to designate lead counsel for plaintiffs in a securities class action. In that case, faced with a dispute among various law firms which sought designation as lead counsel for the class, the court took note that

> "[i]n contrast to situations in which attorney fees are recoverable by statute from one of the parties and where fee claims may be attacked and defended in an adversary proceeding, courts in common fund cases are ... abandoned by the adversary system. Yet the court bears fiduciary

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[220] Swedish Hospital v. Shalala, 1 F.3d 1261 (D.C. Cir. 1993). See also In re Activision Securities Litigation, 723 F. Supp. 1973 (N.D. Cal. 1989).

responsibilities to the class. Under Fed.R.Civ.P. 23(d) the court may make appropriate orders 'for the protection of the members of the class.'....

"Because the class members' standard may not be the same as that of the court, the problem facing the court is how to approximate what the class members would do if they were involved in the decision-making. It seems obvious that in order to decide whether or not to sue, the class would, among other things, demand in advance of the litigation the following information: how much their lawyers will charge for their services and the best price available for those services. The ability of any retrospective determination (i.e., one based on a judge's standard of fairness) to reconstruct this information is doubtful. The point is that in order to obtain the best information available, there must be competition among applicants for lead counsel; competition in turn requires an ex ante determination of the fee award."[221]

The Oracle court directed that each law firm wishing to compete for lead class counsel file an in camera application with the court. Each application was to set out the applicant's qualifications to serve as lead counsel and the percentage of any recovery that the firm would charge in fees and costs.[222] The court received bids from four firms and selected one as representing the best value for the class.[223]

The Oracle approach may offer some advantages by maximizing the interest of the class in getting the best value for legal services and discouraging fast filing to win control of case. On the other hand, the approach may not work in all cases and might lead to other abuses if widely followed. For example, if most courts required competitive bidding for lead counsel, some plaintiff's law firms might have an economic incentive to file as many cases as possible, even if the cases are marginal, underbid to win control of each case,

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[221] In Re Oracle Securities Litigation, 131 F.R.D. 688, 691-92 (N.D. Cal. 1990).

[222] The court directed that the qualifications to be considered would include a detailed description of the role the firm played in each class action it brought or assisted in bringing and the contribution the firm made to the welfare of class plaintiffs. The court also required each firm submitting a bid to certify that its figures were calculated independently and that no part of the bid was revealed to another bidder. In re Oracle Securities Litigation, 131 F.R.D. at 697.

[223] In re Oracle Securities Litigation, 132 F.R.D. 533 (N.D. Cal. 1990).

and then spend a minimal amount of time litigating each case. This approach may also not work well in cases that do not have a lot of money at stake, where demand for control of the litigation among competing firms may be weak or nonexistent.

A number of other proposals to reform the way in which class counsel are paid have also been proposed. The SEC's testimony to the Subcommittee gave "general support" for proposals to curb abuses in class action cases, by prohibiting payment of additional compensation to plaintiffs who represent the class or payment of referral fees by attorneys for a class, by prohibiting class counsel from having a beneficial interest in the securities that are the subject of the litigation, and by prohibiting payment of attorneys' fees out of funds disgorged in SEC enforcement actions.[224]

2. **Class Guardians**.

One reform suggestion made to the Subcommittee was that courts should make greater use of special masters, or guardians, to oversee class action settlements and fee awards.[225] Because of crowded dockets and the unlikelihood that a class member or other party will provide informed critical views on the settlement terms, many observers think that effective judicial review of settlement terms is often unrealistic. A guardian who could have access to discovery material and the opportunity to present the court with independent views on the fairness of the settlement to class members could alleviate this problem. Some courts have recognized the advantages of appointing a guardian for the class to review their attorneys' fee application.

> "The initial difficulty in setting counsel fees when a guardian is not appointed revolves around the defendants' total indifference to the proceedings. Having agreed to contribute a fixed sum of money in settlement of the suit, the proportion of the fund allocated to counsel fees is of no moment to the defendants.... The unfortunate result is the necessity for the judge to assume the advocate's role left unfilled by the defendants' departure. The dilemma thereby created for the Court finds the judge playing 'devil's advocate' on behalf of the disinterested

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[224] McLucas statement, Hearing Record at 117.

[225] See SWIB letter, supra note 70, at 3. See also Macey and Miller, supra note 199 at 45-48; Note, Abuse in Plaintiff Class Action Settlements: The Need for a Guardian During Pretrial Settlement Negotiations, 84 Mich. L. Rev. 308, 310 (1985).

defendants, while at the dame time attempting to exercise his impartiality in making a just determination of reasonable fees....

"Additionally, it is economically impracticable to expect that individual class members will be able to participate in the fee proceedings, or indeed desire to participate. Where the individual recoveries are very small, as in the instant suit, the time and expense of participation would be far in excess of the anticipated benefit. The appointment of a guardian for the class, therefore, provides representation for the class members at a stage of the proceedings where their interests could only be unprofitably protected, and where, not surprisingly, there is normally no class member participation."[226]

Although a few courts have used guardians to approve settlement terms,[227] this approach has not become prevalent, perhaps because of uncertainty over how a guardian should be compensated. Although the courts which have utilized guardians have permitted payment out of the settlement fund, this approach seems undesirable, since it could undermine the guardian's objectivity.[228] An alternative approach might be to require the settling parties to advance the guardian's fees, but in the event that the guardian approves the settlement, to require the guardian to refund the fees advanced by the parties and instead assess the guardian's fee against the settlement proceeds.

3. **Plaintiffs' steering committees.**

Another suggestion made to the Subcommittee was that class members should have the ability in appropriate cases to form a steering committee to control the conduct of their counsel in the litigation. "As in bankruptcy cases, the court could be authorized to appoint a committee of shareholders made up of those with the largest claims at stake to supervise class counsel and provide real client involvement in the case. The committee could be required to competitively select class counsel and to approve any proposed settlement,

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[226] Haas v. Mitchell, 77 F.R.D. 382, 383 (W.D. Pa. 1977).

[227] Haas v. Pittsburgh National Bank, 77 F.R.D. 382, 383-84 (W.D. Pa. 1977); Miller v. Mackey International, Inc. 70 F.R.D. 533, 535 (S.D. Fla. 1976).

[228] See Macey and Miller, supra note 199, at 48.

including the level of fees."[229] Since it is unclear in how many cases class members would be willing to serve in such a role, and whether class members willing to serve would fairly represent the class, it would not be appropriate to require courts to follow this approach. However, it may be reasonable to authorize courts to follow such an approach in cases where the court finds that such a steering committee would work.

4. **Class Referendum**.

It has also been suggested to the Subcommittee that proposed settlements of class actions should be submitted to a vote of shareholders before being submitted to the court for its approval. It appears that such an approach may be cost-effective in some cases, but that the costs and delay inherent in such an approach may make it unfeasible in most instances.[230] However, in conjunction with providing courts authority to appoint a class guardian or steering committee, it may be appropriate to authorize those entities to attempt a class referendum on a settlement proposal if they deem it cost-effective in a particular case.

5. **Auction of Claims**.

Critics have suggested a number of other reforms to minimize the problems created by class members' lack of control over their attorneys. One sweeping suggestion has been to give courts discretion in appropriate cases to permit law firms and defendants to participate in an auction to buy out the class's legal claims.[231] Proponents argue that this would have the following advantages: (i) class members would receive a fast liquidation of their claim.

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[229] SWIB letter, supra note 70, at 3.

[230] The Subcommittee asked two claims administrators for their views on such an approach. Edward J. Radetich, President of Heffler & Company and a witness at the hearings, advised the Subcommittee staff that such an approach might impose considerable effort on banks and broker-dealers because typically 60-70 per cent of class members hold their securities in street name. However, he projected that the overall cost of soliciting and counting votes would be only $2 to $3 per class member. See letter from Edward J. Radetich to Senator Christopher J. Dodd, Feb. 14, 1994. Dennis A. Gilardi, president of Gilardi & Co., a nationally recognized claims administrator, advised the Subcommittee staff informally that a vote by class members would be impractically expensive and slow in most cases.

[231] See Macey and Miller, supra note 199, at 105-110.

and in meritorious cases would tend to receive a higher amount because the incentive for plaintiffs' counsel to collude with defendants to settle claims too cheaply in return for their fees would be removed; (ii) judicial scrutiny of the settlement terms or of attorneys' fees would no longer be required because of the owner of the claim would want to achieve the best outcome and there would be no absent parties whose rights would be prejudiced by the outcome; and (iii) the ability of private litigation to effectively enforce the law would be enhanced, since law firms would bid for cases based entirely on potential merit.

The auction approach also has a number of potential disadvantages, including: (i) defining the claim to be auctioned would be difficult in many cases without the benefit of discovery to refine the scope of the claim; (ii) potential bidders among plaintiffs' law firms might collude in the bidding to keep prices low; (iii) in cases with large stakes there may be too few bidders with financial resources to bid, and in cases with relatively small stakes the cost of learning the case's specific facts in order to formulate a bid might discourage potential bidders.

Conclusions.

The observations on pages 69-70 about the Public Service Company of New Mexico case appear to be supported by other evidence, as well as by the analyses of academic work concerning securities class action litigation. The dynamics of private securities class actions appear to create incentives for plaintiffs' counsel and defendants which work at cross-purposes to the goals of deterrence and investor compensation. There is evidence, based on the outcome of cases such as Public Service Company of New Mexico, that plaintiffs' counsel in many instances litigate with a view toward ensuring payment for their services without sufficient regard to whether their clients are receiving adequate compensation in light of the evidence of wrongdoing. There is an equally strong perception that for both plaintiffs' counsel and defendants, the possible merit of a particular case may have less weight in arriving at a settlement than the amount of insurance coverage available. Legislative proposals such as the ones discussed above may be able to alter these dynamics, by providing means for investor representatives to exert greater control over plaintiffs' counsel, and by tying compensation for plaintiffs' counsel more directly to recoveries received by investors.

PART THREE-- ACCOUNTANTS' RESPONSIBILITIES AND ALLOCATION OF LIABILITY

Introduction

In recent years, the accounting profession has expressed increasing concern about the impact of securities litigation on the viability of accounting firms, and on the incentives for accountants to continue providing audit services, especially to companies that are prone to securities litigation, such as new public companies or companies in "high tech" industries which tend to have volatile stock prices. This has been coupled with changes in the public perception of the accounting profession as a result of the role played by some auditors in the savings and loan crisis of the late 1980s.

These concerns have prompted a number of steps by the profession, such as a report by the Public Oversight Board of the AICPA concerning the profession's liability exposure, and the endorsement by the AICPA of legislation to strengthen the responsibility of auditors to look for and report signs of wrongdoing when they audit the financial statements of public companies. In addition, the profession has also approached Congress seeking relief from what they characterize as their excessive liability for wrongdoing committed by others. In order to assess these concerns, the Subcommittee's hearings included consideration of the relationship between private securities litigation and the role of auditors in the financial disclosure system.

A number of developments in recent years have raised questions about the duties of both accountants and lawyers to the companies that hire them, on the one hand, and the investors (or in the case of insured financial institutions such as savings and loans, government regulators) who rely on the integrity of their work. In particular, accountants and lawyers have both faced increasing legal exposure and public criticism as a result of the savings and loan crisis.

U.S. District Court Judge Stanley Sporkin recently spoke on his concerns about the duties which may be owed by lawyers and accountants to third parties. In an address at a conference addressing these issues Judge Sporkin stated:

> "It is indeed a sad commentary when it is realized that without the complicity of this nation's lawyers and accountants the financial crimes

of the roaring 80's simply would not have occurred. This is an undeniable fact and yet few if any of this nation's professional or other leaders have spoken out on the subject....

"If the professions are incapable of reforming themselves, the reformation must come from our government leaders. If our professions are hiding behind continued rules and practices that no longer have any vitality or place in today's society, then they must be drastically altered or shed completely. The stakes are too high and the professions have too large a role in the performance of our private business and financial machinery to shun their responsibilities to make our system perform better."[232]

These concerns raise questions for both accountants and lawyers about the need to develop stronger self-discipline, to redefine ethical constraints, and to reconsider the nature of duties owed to clients and others.[233] Much of that debate is beyond the scope of this report, but those broader questions provide a necessary context for appraising the issues surrounding litigation liability faced by accountants.

A. PRIVATE SECURITIES LITIGATION AND THE ACCOUNTING PROFESSION

1. Role of the Accounting Profession in the Securities Markets

The role of the accounting profession under the federal securities laws was described by another Senate Subcommittee as follows:

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[232] The Honorable Stanley Sporkin, An Address to the American Law Institute - American Bar Association Conference on Lawyer and Accountant Liability and Responsibility on the Subject of Lawyer and Accountant Liability, December 10, 1993.

[233] For discussions of many of these questions as they pertain to securities and banking lawyers, see Doty, Regulatory Expectations Regarding the Conduct of Attorneys in the Enforcement of the Federal Securities Laws: Recent Development and Lessons for the Future, 48 Bus. Law. 1543 (1993); Baxter, Fiduciary Issues in Federal Banking Regulation, 56 Law & Contemp. Probs. 7 (Winter 1993); Fisher, Nibbling at the Chancellor's Toesies: A "Roguish" Concurrence With Professor Baxter, 56 Law & Contemp. Probs. 45 (Winter 1993).

"The primary purpose of the Federal securities laws is to instill public confidence in the reliability and accuracy of information reported by publicly-owned corporations. Doubts as to the reliability and accuracy of such information impair its usefulness to the public for making efficient economic and social decisions, and defeat the purposes of the securities laws. Independent auditors perform a key function in achieving the goal of the Federal securities laws because they provide the means for independently checking and confirming the information reported by corporations."[234]

Evolution of the Profession. Prior to the enactment of the federal securities laws in the 1930s, accountants were generally considered to be primarily responsible only to the management of the companies which they were hired to audit. For example, Justice Benjamin N. Cardozo, when he sat on the New York Court of Appeals, ruled in a landmark case that under New York law auditors should not be liable to third parties not in privity with the auditors, except where the auditors had engaged in fraud.[235] Judge Cardozo found that the auditor's duties ran to the client, and that others to whom the client might provide audited financial statements were not entitled to legal protection against the auditor's negligence.

Events leading to enactment of the federal securities laws, particularly the market crash of 1929, illustrated that better protection was needed for investors who relied on audited financial statements. When Congress enacted

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[234] The Accounting Establishment, Staff Study by the Subcommittee on Reports, Accounting and Management, Senate Committee on Government Operations (March 31, 1977) at 1.

[235] Ultramares Corp. v. Touche, 255 N.Y. 170 (1931). Cardozo's decision in Ultramares contrasts with his landmark opinion in MacPherson v. Buick Motor Co., 217 N.Y. 382 (1916), in which he held that a manufacturer of a defective automobile was liable for harm that was reasonably foreseeable as a result of its negligence. MacPherson overturned the doctrine of contractual privity, which had limited manufacturers' liability to those with whom it had a direct contractual relationship. In Ultramares Cardozo noted that while the MacPherson "assault upon the citadel of privity is proceeding... apace," the foreseeability approach should not be applied to accountants' certifications. Cardozo pointed out that imposing expansive liability might "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class...." 255 N.Y. at 179. For a discussion of the policy arguments for and against the Ultramares approach to accountants' liability for negligence, see John A. Siliciano, Negligent Accounting and the Limits of Instrumental Tort Reform, 86 Mich. L. Rev. 1929 (1988)(hereafter, "Siliciano").

the federal securities laws, it considered requiring companies to submit their account balances and internal financial records for verification by government auditors.[236] After hearing testimony from representatives of the accounting profession that private auditors could perform the audit function more effectively, Congress chose to entrust the private accounting profession with this responsibility.[237] The Supreme Court has succinctly described the role which auditors have come to play as a result of this delegation:

> "By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."[238]

Partly as a result of this important franchise, accounting firms responsible for auditing companies registered with the SEC have grown enormously. According to one critic of the accounting profession, one major accounting firm has grown from revenues of less than \$1.5 million in 1932 to almost \$2.7 billion in 1992 (an increase of 180,000 per cent).[239]

It should be noted that while much of this growth has been in the audit area, much has also come in other business areas, particularly management advisory services. For example, it was reported that in 1992 each of the six largest accounting firms received at least 20 per cent of its U.S. revenue from management consulting services, and that the largest U.S. accounting firm derived only 35.2 per cent of its U.S. revenue from auditing work, while 44.9 per cent of its revenues came from management consulting services.[240]

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[236] Hearings on S. 875 Before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 56-60 (1933).

[237] Id. at 55-60.

[238] United States v. Arthur Young, 465 U.S. 805 (1984).

[239] Weiss statement, Hearing Record at 402.

[240] See A Year of Refocusing, Public Accounting Report, March 31, 1993 at 1. This report also indicated that each of the six firms had worldwide revenue for all services

Regulatory Framework and Professional Standards As a result of the expanded role of accountants, professional standards for accountants have developed significantly since the 1930s. Specifically, the need for auditors to maintain economic independence from their clients to ensure the auditor's objectivity has become widely acknowledged,[241] and professional bodies have evolved which have become the principal standard-setters for accounting principles and auditing standards.

The Financial Accounting Standards Board ("FASB") is the private sector body with primary responsibility for setting generally accepted accounting principles ("GAAP"). The SEC, however, can exercise its authority under the federal securities laws to set GAAP, thereby overruling or bypassing the FASB. Similarly, the Audit Standards Board ("ASB"), a private body under the auspices of the AICPA, is the initial arbiter of generally accepted audit standards ("GAAS").[242]

The disciplinary system to police against infractions of GAAP and GAAS is also largely a matter of voluntary self-policing. The most serious departures

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ranging from 5 to 7 times the amount of U.S. revenue generated by auditing services. Some critics of the accounting profession strongly contend that the growing efforts of major accounting firms to offer consulting services to public companies which they also audit weakens the independence of their audit work. See Prepared statement of Professor Abraham J. Briloff, Hearing Record at 374.

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> "The credibility of the independent audit is essential to public trust, the keystone of the financial reporting system. The accounting profession prides itself on the integrity and objectivity of its members. The future of our profession, not to mention our livelihood, rests on this reputation.
>
> "A few recent high-profile financial scandals have, however, called auditors' independence into question. Neither the accounting profession not the financial markets can afford an erosion of public confidence. For that reason, auditors must scrupulously preserve their objectivity, in reality and appearance."

American Institute of Certified Public Accountants, Meeting the Financial Reporting Needs of the Future: A Public Commitment from the Public Accounting Profession, at 4.

242 The SEC has long been presumed to have the ultimate authority to set GAAS, although the SEC in practice has usually delegated that function to ASB and its predecessors in the private sector.

from GAAP or GAAS may result in SEC administrative sanctions,[243] and if they also entail violations of the federal securities laws by the accountant, may result in other action by the SEC or liability in private litigation. Professional transgressions are also dealt with through state boards of accountancy, which have the ability to suspend or decertify accountants from practice.

In addition to this disciplinary structure, AICPA member accounting firms which perform audit work for companies registered with the SEC are required to join the AICPA's SEC Practice Section ("SECPS"). SECPS, acting through its Peer Review Committee, sets certain requirements for quality control and periodic review of those controls within each member firms by auditors from outside the firm.[244] For example, members of SECPS are required to submit to triennial peer reviews by audit teams from other SECPS members.[245] The SECPS is also empowered to take disciplinary action against accountants who fail to meet SECPS or professional standards. However, the SECPS's disciplinary process is widely viewed as ineffective. "[C]ongressional hearings have revealed that an apparent reluctance to impose sanctions and disciplinary actions, the confidentiality of the proceedings, and an inherent skepticism that any group can effectively evaluate its own

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[243] The SEC brings administrative actions against accountants under Rule 2(e) of its Rules of Practice for violations of professional standards. However, due to resource constraints and other factors, the SEC's administrative process has become slow. See Report of the Administrative Task Force on Administrative Proceedings of the United States Securities and Exchange Commission, at 20 (February 1993). Changes in the SEC's administrative procedures currently being implemented may alleviate this problem.

[244] SECPS has approximately 1,200 members, who audit 14,000 companies which are registered with the SEC. Approximately 300 accounting firms, which are not SECPS members because they do not belong to the AICPA, audit 500 companies registered with the SEC. SEC 1992 Annual Report, at 65.

[245] "The peer review includes reviewing relevant material setting forth the firm's quality control standards and practices; determining whether the SEC Practice Section's membership requirements, including such matters as continuing professional education requirements, have been satisfied; and examining selected audits to determine whether they were conducted properly and in accordance with the firm's and the profession's quality control standards." In the Public Interest: A Special Report by the Public Oversight Board of the SEC Practice Section, AICPA, at 16 (March 5, 1993)(hereafter "POB Report").

members have created the perception that the profession's peer review program is not fulfilling expectations."[246]

Another arm of SECPS, the Quality Control Inquiry Committee ("QCIC"), receives reports of allegations of audit deficiencies made against any SECPS member in any legal proceeding. QCIC conducts a limited review of the alleged audit deficiencies to determine if they reflect any systemic problem with a firm's quality control procedures, or if the alleged audit failure suggests any need to consider changes to GAAS or to SECPS's quality control requirements. QCIC reviews are subject to significant limitations. For example, QCIC does not purport to investigate whether any audit failure has actually occurred, only whether the SECPS's quality control standards are working properly. QCIC reviews also usually follow the conclusion of litigation, and therefore it can take years for the QCIC to resolve a matter.

Legal Liabilities. Under the federal securities laws, accountants play a critical role, and accordingly have come to face broader potential legal liabilities to investors. For example, Section 11 of the Securities Act permits investors to sue auditors, as well as officers, directors and other professionals, for any material misstatement or omission in a registration statement. As applicable to auditors, Section 11 liability provides that an auditor whose certification of a financial statement was filed as part of the registration statement in connection with a public offering of securities would be liable for damages incurred by investors attributable to misstatements of omissions in the financial statements unless the auditor had, after reasonable investigation. a reasonable basis to believe that the financial statement did not contain a material misstatement or omission.

Under Section 10(b) of the Exchange Act, an auditor who certifies a financial statement which contains material misstatements or omissions may be liable to investors who rely on that financial statement if the auditor "knowingly" or "recklessly" deviated from generally accepted auditing standards in conducting the audit.[247] Some courts have also held that an accountant

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[246] Price Waterhouse, Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence 46 (1985) (hereafter, "Price Waterhouse Report").

[247] The legal theory under which auditors are generally pursued for wrongdoing committed by the issuer of the securities is aiding and abetting violations of § 10(b) of the Exchange Act. This theory of liability is no longer available as a result of the recent decision of the Supreme Court in the Central Bank case described at page 6 above. However, it is possible that as a result of Central Bank plaintiffs will seek to hold

can be liable under Section 10(b) if it subsequently learns that its opinion or certification was incorrect at the time it was issued,[248] or that it may have a duty to update its opinion or certification if it learns of subsequent events which cause the financial statements which it certified to become materially incorrect.[249]

The "Expectation Gap" and Other Concerns The current role of the accounting profession was recently summarized by the SEC:

> "In contrast to the primary role of management in the preparation of financial reports, auditors are responsible for testing and probing to make sure that management's financial data stands up to independent verification. Thus, auditors -- who must meet standards of complete

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auditors liable as primary violators of §10(b), on the theory that the auditors' certification was a false or misleading statement because it did not disclose the auditors' knowing or reckless departure from GAAS. This theory has not been fully developed in the courts, and its efficacy as an alternative to aiding and abetting liability is unclear.

[248] See Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981), cert. denied, 458 U.S. 938 (1982); Summer v. Lan & Leisure, Inc., 571 F.Supp. 380, 386 (S.D. Fla. 1983).

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> "[S]tanding idly by while one's good name is being used to perpetrate a fraud is inherently misleading.... It is not unreasonable to expect an accountant, who stands in a 'special relationship of trust and confidence vis-a-vis the public,' ... and whose 'duty is to safeguard the public interest,' ... to disclose fraud in this type of circumstance, where the accountant's information is obviously superior to that of the investor, the cost to the accountant of revealing the information minimal, and the cost to investors of the information remaining secret potentially enormous."

Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1044-45 (11th Cir. 1986), cert. denied, 480 U.S. 947 (1987). But see Robin v. Arthur Young & Co., 915 F.2d 1120 (7th Cir. 1990) and Latigo Ventures v. Lavenworth & Horwath, 876 F.2d 1322, 1327 (7th Cir. 1989), in which the court said:

> "It is not the law that whenever an accountant discovers that his client is in financial trouble he must blow the whistle on the client for the protection of investors.... There is no actionable nondisclosure without a duty to disclose, and in deciding whether there should be such a duty a court should attend to the practical consequences. Relations of trust and confidence between the accountant and client would be destroyed if the accountant were duty-bound to make continuous public disclosure of all the client's financial adversities. And the costs of auditing would skyrocket to compensate the accounting profession for the enormous expansion in potential liability, not to mention the increase in the costs of publication."

'independence' from the firm that they are auditing -- play a crucial role in deterring or exposing financial statement fraud. Auditors are not and should not be seen as insurers of the financial statements they have audited. However, they should be expected to serve as vigilant and effective watchdogs against the use of false or inaccurate financial information."[250]

Observers of the accounting profession have become concerned that an "expectation gap" has become acute between what the investing public expects from independent auditors and the performance of the profession. The Public Oversight Board of the AICPA recently addressed this "expectation gap":

> "The accounting profession has suffered a serious erosion of public confidence: confidence in its standards, in the relevance of its work and in the financial reporting process. The reasons for this are not hard to identify. In some cases, not long before and entity failed, it received an auditor's report giving no indication that the entity was in its latter days. How could it be, the intelligent and thoughtful layman asks, that the bank or other business was so near its demise and the auditors could not see it?....
>
> "While the Board believes that a better understanding of the limits of financial statements and audits can do much to close the expectation gap, ... the Board believes the principal obligation for closing the gap rests with the profession and that only improved performance and an expansion of its responsibilities can close the gap to the extent necessary if the profession is to serve the public interest and satisfy the reasonable expectations of users of financial statements.
>
> "The Board believes that the users of audited financial statements must obtain <u>some measure</u> of additional assurance that the company's affairs are being conducted in accordance with specified laws (to the extent auditors have the ability to make such judgments); that the company's internal controls meet [certain] criteria...; and that

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[250] Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Hearing before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, 103d Cong., 1st Sess. (Feb. 18, 1993) at 4.

management is not manipulating its financial reports or committing other frauds.[251]

In addition to these concerns, a number of other questions have been raised about conflicts between public expectations of auditors and the way that the profession currently operates. These concerns were summarized in a report by a major accounting firm:

> "Critics charge that the current so-called 'cutthroat' competition for audit engagements has undermined two characteristics auditors must possess -- the highest possible standards of performance, and independence. Allegations have been made that price competition has encouraged sub-standard auditing and corner-cutting, thereby increasing the possibility that danger signals of financial failure and fraud will be missed.
>
> "Allegations have also been made that competitive pressures are undermining independence in at least two ways. First, auditors have been accused of agreeing to questionable accounting treatments or giving undeserved or unqualified opinions in order to attract or retain clients. Second, the performance of major consulting engagements for audit clients has been said to compromise independence."[252]

2. Impact of Litigation Exposure on Accountants

a. Evidence Concerning Exposure

"Big Six" Study In response to a request from the SEC, the six largest accounting firms recently prepared a report, which they provided to the Subcommittee, setting out information on the impact that securities litigation has had on their financial condition. The report was based on a data base derived from information provided to a law firm by each of the six firms concerning cases filed or resolved during calendar years 1990, 1991 and 1992, as well as internal financial information. The report stated that "the cost to the accounting profession of insuring itself against threatened legal action and

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[251] POB Report, supra note 245, at 31, 33-34 (emphasis in original).

[252] Price Waterhouse Report, supra note 246, at 7-8.

the cost of defense and settlements have created a grave threat to the profession's continued existence."[253]

The report claimed that:

- the net costs of litigation and insurance premiums for accounting firms grew from $404 million in 1990, or 7.7 per cent of total accounting and audit revenue, to $598 million, or 10.9 per cent of accounting and audit revenue between 1990 and 1992, and as of the date of the report represented 14 per cent of those revenues;

- insurance companies are increasing both premiums and deductibles, or otherwise curtailing coverage to the accounting profession;

- at the end of 1992 the amount of claims in pending cases totaled $30 billion, or roughly 20 times the aggregate capitalization of the six firms;

- Under the current liability system,

  "[m]any defendants are forced into pre-trial settlements that deny them a judgment on the merits because, economically, they cannot bear the cost and risk of losing in the face of three very large risks inherent in the current system. These risks are: punitive damages, a lack of proportionate liability, and juries who may have grossly inflated an erroneous perception of the availability of insurance and the ability of businesses to pay large judgments."[254]

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[253] The six firms are Arthur Andersen & Co., Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG Peat Marwick and Price Waterhouse. Big Six study, supra note 82.

[254] Big Six study, supra note 82, Hearing Record at 670. Punitive damages are not available to private litigants under the federal securities laws, except that § 21A(e) of the Exchange Act authorizes the SEC to award a bounty to informants in limited circumstances. Punitive damages are available under the laws of many states in cases involving auditor malpractice.

Because of these alleged abuses, as well as joint and several liability, "accountants and auditors become one class of defendants who are to foot the bill for the failures of others in the business system."[255]

The report included the following table.

TABLE I -- AUDIT-RELATED LITIGATION, ALL CASES

	1990	1991	1992
Number of Suits Filed	192	172	141
Total Amount of Awards & Settlements Paid	$89.6M	$160.3M	$752.4M
Amount of Awards & Settlements Per Audit Partner	$19,865	$37,900	$185,737
Number of Cases Settled	52	67	115
Amount of Settlements	$54.4M	$146.6M	$748.3M
Number of Cases Dismissed	23	29	79
Number of Cases Tried	9	7	15
Number of Verdicts for Defendants	3	3	12
Number of Verdicts for Plaintiffs	6	4	3
Total Amount of Awards to Plaintiffs	$35.2M	$13.7M	$4.1M

This information illuminates the larger question about how litigation exposure -- whether under state or federal law -- may affect the financial stability of the largest accounting firms. The table suggests that there are some countercurrents involving auditor's liability. In certain respects, private litigation is exhibiting favorable trends toward auditors. The number of suits filed against auditors appears to be diminishing markedly, and the auditors' success in obtaining dismissals has grown sharply. Of the relatively few cases which have gone to trial, auditors have won more than half. On the other

[255] Big Six study, supra note 82, Hearing Record at 669-70.

hand, the amount of payouts under judgments and settlements has grown rapidly, from $89.6 million to $752.4 million.

Representatives of these six firms have advised the Subcommittee staff that the majority of cases pending against the firms arise under state law, and only about 30 per cent of pending cases include claims under the anti-fraud provisions of the federal securities laws. Only a very small fraction of cases are exclusively federal securities law anti-fraud claims. In response to subsequent inquiries from the SEC and the Subcommittee, the six firms provided the following additional information on audit-related cases which included federal securities law claims:

TABLE II -- AUDIT-RELATED CASES CONTAINING ANY FEDERAL SECURITIES LAW CLAIMS, INCLUDING RULE 10B-5 CLAIMS[256]

	1990	1991	1992
Total Amount of Awards and Settlements Paid	$58.5M	$87.5M	$373.9M
Amount of Awards & Settlements per Audit Partner	$12,968	$20,686	$92,298
Number of Cases Settled	12	27	37
Amount of Settlements	$36.5M	$79.5M	$373.9M
Number of Cases Dismissed	7	11	25
Number of Cases Tried	1	4	0
Number of Verdicts for Defendants	0	3	0
Number of Verdicts for Plaintiffs	1	1	0
Total Amount of Awards to Plaintiffs	$22M	$8M	$0

256 Includes all cases containing any federal securities law claim, even if other federal or state claims were also alleged in the complaint.

The information provided by the six firms concerning cases which include federal securities law claims suggests the same contrary sets of trends noted above for the larger universe of cases. While no information was provided about the number of cases with federal claims that were filed, cases including claims under the federal securities laws display an increasing trend toward dismissal, with the number of cases dismissed rising from 7 to 25 between 1990 and 1992. Moreover, the accounting firms won more than half of the small number of cases that went to trial. On the other hand, the total amount of judgments and settlement payouts in these cases rose from $58.5 million in 1990 to $373.8 million in 1992.[257] As discussed at page 103 below, most of this rise is accounted for by a very small number of very large cases which settled in 1992, but even with that adjustment that payouts rose by 144 per cent between 1990 and 1992.

The six firms suggested that, in addition to mounting liability, their financial stability is also being threatened by legal costs in defending cases where the plaintiff's claim is weak. For example, with regard to federal securities law claims based on Section 10(b), the report stated that "60 per cent of the nearly 100 10b-5 cases closed out during the past two years... brought payments to plaintiffs of less than $1.5 million. Yet these cases cost the six firms many times that amount in legal fees. These facts demonstrate that, under the current regime, a large share of the firms' resources is being drained by lawsuits that have little or no success in court."[258] This point may be buttressed to some extent by the recent weakening of the ability of federal courts to impose attorneys fees and other sanctions on plaintiffs who bring cases that lack an adequate legal or factual foundation.[259] This could make it more likely that a plaintiff might name an accounting firm as defendant without any reasonable basis to believe that the accounting firm contributed to the alleged violation.[260]

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[257] The supplement to the report indicates that liability exclusively under Section 10 of the Exchange Act accounted for half of the six firm's total securities law-related settlements over the 1990-92 period. Letter from Mark H. Gitenstein and Andrew J. Pincus to Walter Scheutze, September 24, 1993, attachment (B), Hearing Record at 735 (hereafter "Big Six Supplement").

[258] Big Six study, supra note 82, at 672.

[259] See pages 37-38 above.

[260] This concern may be offset to some degree by the data noted above indicating a markedly upward trend in the number of cases dismissed by courts.

Limitations of Big Six Study. It is unclear how much of the increase in settlements and award payouts by the Six firms might be due to a few unusually large settlements or judgments. In view of reports of several very large judgments against accounting firms within the past two years, the Subcommittee and the SEC both asked the six firms for more information about what impact a few large cases might on the overall data, but the firms were unable to provide that information.[261] However, the Subcommittee staff has learned of what appear to be the five largest settlements by the six firms during 1990-92, all of which occurred in 1992. The settlements were as follow:

- A $112.6 settlement by Ernst & Young with the Federal Deposit Insurance Corporation ("FDIC") arising out of audits of United American Bank.[262]

- $95 million and $50 million settlements by Coopers & Lybrand in two private securities class actions brought by stockholders and bondholders arising out of audits of Miniscribe, Inc.

- A $63 million settlement by Ernst & Young in private securities class action arising out of audits of American Continental Corporation.

- A $22.9 million settlement by Arthur Andersen in a private securities class action arising out of audits of American Continental Corporation.

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[261] The law firm representing the six accounting firms responded that it could not provide that information because the pooled information from its clients did not include any case-specific data. See letter from Mark H. Gitenstein to Senator Christopher J. Dodd, July 21, 1993 at 2; letter from Mark H. Gitenstein and Andrew J. Pincus to Walter Scheutze, September 24, 1993, Hearing Record at 732.

[262] According to press reports, this was part of a "global settlement" of $400 million by which Ernst & Young resolved a number of claims with the FDIC and RTC arising out of Ernst & Young's audits of several federally insured banks which later failed. See David LaGesse, FDIC Lists How It Divided $400 Million Settlement, Dallas Morning News, December 5, 1992, at 1. It appears that the other claims involved in the settlement were not filed in court. Consequently, they were presumably not included in the numbers provided by the six firms.

Another limitation on the information from the six firms arises because the study does not distinguish between government and private claims.[263] This distinction is significant because, to the extent that auditors' liability exposure is generated by claims brought by the government, a host of other issues may come to bear, such as the extent to which government claims are brought to recoup expenses inflicted on taxpayers as a result of the failure of government-insured financial institutions.[264]

To develop additional information on this point, the Subcommittee staff asked the FDIC and the Resolution Trust Corporation ("RTC") about settlements that they reached with the six firms in litigated cases in 1990-92. The FDIC advised the staff that during 1990-92 it settled two cases against the firms, one case in 1991 for a total of $12.2 million, and two cases in 1992 for a total of $130 million.[265] The RTC reported that during 1990-92 it settled just one case involving any of the six firms, in 1992 for $5.07 million.[266]

The data submitted by the six firms therefore appears to be significantly affected by a few very large private settlements and the settlements with the

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[263] It is also very unclear to what extent the liability problem which the report addresses is posed by federal laws other than the securities laws.

[264] A representative of the six firms has informed the staff that

> "[t]he bulk of the tremendous litigation exposure described in the white paper arises from private suits and not government actions. Based on the data available at this time, we have found only 6 of the 187 cases closed in 1990 and 1991 that were brought by federal or state governments. None of those six cases contained claims under the federal securities laws.... The total judgments and settlements paid in those six cases was $26.7 million."

Letter from Mark H. Gitenstein to Senator Christopher J. Dodd , July 21, 1993, at 2.

[265] The FDIC did not settle any cases with the six firms in 1990. These figures are for cases that were filed in federal court. In addition to cases filed in court, the FDIC advised the Subcommittee staff that it settled a substantially larger number of claims against the six firms in 1991 and 1992 without filing a lawsuit. In 1991 the FDIC settled one such claim for $20 million. In 1992 the FDIC settled 20 such claims for $160 million.

[266] In addition to the one case which was settled after filing in court, the RTC, like the FDIC, settled a much larger number of claims against the six firms without resorting to litigation. The RTC settled three such claims against the six firms for a total of $54.5 million in 1991 and 17 such claims for $124.3 million in 1992.

FDIC and RTC. For all audit-related litigation (Table I) the total settlements and awards paid, excluding the four largest private settlements and the settlements with the FDIC and RTC, were \$89.6 million in 1990, \$148.1 million in 1991, and \$386.43 million in 1992. These adjustments have the effect of reducing the percentage increase in total settlements and awards from 1990 to 1992 from 740% (according to Table I) to 331%.

If the Big Six study's total settlements and awards figures from cases containing federal securities laws claims (Table II) is reduced by the values of the four largest private settlements the figures are \$58.5 million in 1990, \$87.5 million in 1991, and \$143 million in 1992. This represents a reduction in the percentage increase between 1990 and 1992 from 539 per cent (according to Big Six study) to 144 per cent. These adjustments to the Big Six Study data indicate that much of the substantial increase in audit-related settlements between 1990 and 1992 is attributable to government claims and a small number of very large settlements. Nevertheless, the adjusted numbers still demonstrate a pronounced upward trend in payouts.

A third limitation on the study is that much of the information provided does not distinguish between claims under the federal securities laws and claims under state law. The six firms also have not clarified the dollar amount of the \$30 billion in pending claims that are not based on the federal securities laws.[267] This distinction could be significant, since auditors' liability under many state laws differs significantly from liability standards under the federal securities laws. For example, auditors can be liable under a negligence standard for malpractice under state law, while there is no corresponding federal securities claim for simple malpractice. Punitive damages are available

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[267] The subcommittee has been informed by counsel for the six firms that litigation under the federal securities laws accounts for roughly 30 per cent of the six firms' potential liability exposure.

It also is unclear whether the \$30 billion estimated exposure takes into account cases in which plaintiffs may be asserting untested legal theories or making overly aggressive damage estimates in order to inflate their claims for purposes of settlement negotiations.

In addition, it is unclear to what extent the Supreme Court's recent Central Bank of Denver decision, discussed at page 6 above, may have reduced accountants' exposure by eliminating private claims for aiding and abetting violations of Section 10(b) of the Exchange Act. As discussed at page 115-16 below, these claims had been a significant source of auditor liability.

to private litigants in many states, but not under the federal securities laws.

The information provided by the six firms also sheds little light on the extent to which insurance coverage might reduce their liability exposure. While the report noted that "future commercial insurance availability will be severely limited, with extremely high deductibles -- if the six firms are able to obtain outside insurance at all", the report did not provide detailed information on the six firms' current insurance coverage.[268] The Subcommittee has been informed that the number of insurance firms offering coverage has increased from one in 1985 to 10 today, suggesting that concerns about the future of insurance coverage of accounting firms may be overstated.[269] The accounting profession has provided some information suggesting that deductibles and premiums are extremely high, and coverage reduced.[270] On balance, the extent to which insurance coverage for the accounting profession has become inaccessible or unaffordable is not clear.

Marino Study. A recent study by Steven and Renee Marino examined securities class action settlements involving, inter alia, accountants, attorneys, or underwriters.[271] The Marino study examined 229 securities class action cases.[272] Their study included 50 cases in which accounting defendants settled for amounts that were publicly disclosed.

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[268] Big Six study, supra note 82, Hearing Record at 664.

[269] Despite Litigation Crisis, Insurance Bargains Abound, Accounting Today, June 7, 1993, at 16.

[270] The only information which the Subcommittee has received on this point is contained in a letter from an insurance broker which stated that less than 1% of the companies and syndicates in the property and casualty insurance industry are willing to provide professional indemnity coverage for large U.S. accounting firms, and that the cost of buying coverage is now at least 25% of the total amount recoverable under the policy. The letter also indicated that major U.S. accounting firms cannot obtain deductibles of less than $45 million per claim, and cannot buy coverage much beyond $100 million per claim. The letter observed that "large accounting firms are viewed in much the same way as other definable business sectors with special loss generating characteristics, such as aircraft liability, nuclear fuel liability and... environmental risks." Attachment to letter from Jake L. Netterville to Senator Christopher J. Dodd, September 20, 1993, at 2.

[271] Marino study, supra note 146.

[272] The sample size represents securities class action cases from April 1989 through November 1993 where at least one accountant, attorney, or underwriter was named as a defendant and the case was eventually settled. Marino study, supra note 145, at 3.

The study found that the accounting profession has been subject to a large portion of the overall liability in those cases in which it was involved. On average, the accounting profession's contribution in those cases where all the parties settled represented 39 per cent of the total. The six largest accounting firms paid 82 per cent of the total settlement amount paid by accounting firms in the survey. The total number of cases settled by the six firms rose from 12 in 1991 to 28 in 1993. The average settlement payment by the six firms rose from between $1 and $2 million prior to 1991 to over $6 million in 1991, to $24.7 million in 1992, but fell to $9.5 million in 1993.[273]

According to the study, "it appears that accountants are acting as deep pockets due to the joint and several liability laws."[274] The study found that in those cases where the issuer was in bankruptcy the average settlement paid by accountants was $8.4 million versus $2 million average payment when the issuer was not in bankruptcy. Furthermore, in those cases where all the parties settled and the issuer was in bankruptcy the accountants paid an average of 58 per cent of the total versus 23 per cent of the total when the issuer was not bankrupt. The Marino study also found that, in contrast to accountants, there was no statistically significant evidence that attorneys or underwriters faced greater liability in cases in which the issuer was bankrupt.

The Marino study also attempted to analyze settlements in terms of the degree of severity of the alleged violation. It differentiated cases according to whether the principal wrongdoing alleged in the complaint involved what the authors characterized as "flagrant fraud" (e.g., insider trading, embezzlement, fabricated sales, etc.) and "non-flagrant fraud" (e.g., misleading forecasts or misstated income or balance sheets). The study found that compared to attorneys and underwriters, accountants were more likely to be connected with cases alleging flagrant fraud.[275] In 19 cases where flagrant fraud was alleged, accountants settled for an average of $10.5 million, whereas in 31 non-

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[273] Id. at 33. The Marino Study states that "an analysis of disclosed accountant settlements by industry shows that the banking/S&L industry had the highest concentration of disclosed settlements, representing 24% of all cases and 42% of all dollars during the 1989 to 1993 time frame." Id. at 34.

[274] Id. at 35.

[275] Flagrant fraud is differentiated from non-flagrant fraud by the intent of the defendants and the category consists of insider trading, market manipulation, embezzlement and other fraud (ponzi schemes, fabricated sales, undisclosed felony records of key individuals etc.). Id.

flagrant fraud cases accountants settled for an average of $2.1 million.[276] The study reported that in cases which involved complete settlements of flagrant fraud allegations, accountants paid 71 per cent of the total versus 26 per cent in non-flagrant fraud cases.

Conclusions from Marino Study. The fact that both the number of settlements and the average dollar settlements for 1992 and 1993 appear to be significantly higher than in earlier years lends support to the concerns voiced by many in the accounting profession. Moreover, the Marino Study notes that

> "[b]ankruptcy of the issuer does not have a statistically significant effect upon the amount shareholders recover in a securities class action law suit settlement. Neither does it affect attorney or underwriter settlements in a statistically significant way. However, accountants do end up paying about two and a half times the percentage of the total settlement when the issuer is bankrupt versus when it is not. This supports their claim that they are hurt by joint and several liability laws."[277]

Balanced against this is the study's finding that accountants pay the most in cases in which they audited clients alleged to have committed flagrant fraud. The Marino Study concludes from this that the accounting profession should "reevaluate their stance towards discovery and disclosure of fraud by their clients as a means of reducing their securities class action litigation liability exposure."[278] Beyond this, the significance of the observation that auditors pay more in cases involving flagrant fraud is unclear. The study does not attempt to evaluate the role played by auditors in particular cases. It may be that an auditor is typically less blameworthy in the case of a flagrant fraud, such as embezzlement or insider trading, which may involve carefully concealed acts by a vary small number of participants, than it is in a case involving misstated income statements or balance sheets. If so, the pattern observed by the Marino study may suggest that auditors' settlements runs counter to their culpability.

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[276] As discussed in Appendix B, the Marino study asserts that this 5 to 1 difference indicates that the merits of the case do matter in determining settlement amounts, contrary to Janet Cooper Alexander's article. Id. at 37.

[277] Id. at 51.

[278] Id.

Testimony Reflecting Auditors' Concerns. In addition to the studies provided to the Subcommittee and to the SEC, leaders of the accounting profession also addressed concerns about the profession's current liability exposure. Jake L. Netterville, the Chairman of the AICPA, testified that litigation exposure in both federal courts and state courts was having a deleterious impact on public auditing. He cited studies suggesting that larger companies are avoiding clients with greater potential for litigation, such as start-up companies, and smaller accounting firms are withdrawing entirely from auditing companies with publicly traded stock. He also noted that auditors have become more reluctant to assume new responsibilities in areas such as auditing forward-looking financial data, and auditing expanded disclosure of certain risks and uncertainties.[279]

Mr. Netterville's concern about the threat of litigation exposure to the future of the accounting profession also was expressed by A.A. Sommer, Jr., a former SEC Commissioner and the Chairman of the Public Oversight Board of the AICPA's SEC Practice Section.[280] Sommer also believed, based on the Public Oversight Board's experience overseeing reviews of auditing quality issues raised by litigation, that accountants were particularly prone to spurious law suits.[281] Sommer warned that "it is not beyond the pale to believe... that one or more major firms may be ultimately bankrupted, wiped out, with loss not only of the partnership's assets, but harsh damage to the solvency of the individual partners." Sommer saw wide repercussions from such a failure.

> "Bright young people would shy away from an occupation which harbored the threat that the fruits of a lifetime of outstanding professional endeavor could be wiped out because of the misconduct of one of hundreds and thousands of partners. Existing partners and other professionals in surviving firms would seek other, less risky employment. Young and small enterprises and high-risk enterprises which provide most of the new jobs in our country would find it difficult to secure a

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[279] Netterville statement, Hearing Record at 348.

[280] The Public Oversight Board was created by the AICPA in 1977 to oversee and the operations of AICPA programs which provide peer review of auditors who audit clients registered with the SEC, and which review audit quality issues raised in litigation. Although funded by the AICPA, the Public Oversight Board has the power to select its own members and to hire and set compensation for its own staff. See POB Report, supra note 245, at iii.

[281] Sommer statement, Hearing Record at 352-53.

report on their financial statements satisfactory to lenders and investors."[282]

Mr. Sommer acknowledged that "there has been an erosion of public confidence in financial reporting in this country... and that there are substantive reasons for that erosion."[283] Sommer pointed out that the Public Oversight Board had put forward recommendations for steps to improve auditing standards which the AICPA has since endorsed and promised to attempt to effect. Sommer also noted that civil liability for accountants was necessary to compensate investors, and that "the threat of civil liability, along with the danger of SEC enforcement actions, AICPA ethics proceedings, and state disciplinary measures, is a powerful stimulus to competent performance and meticulous care."[284]

Responses of Critics to Concerns About Liability Exposure. Critics of the accounting profession strongly took issue with the concerns expressed by the AICPA and the major accounting firms, and argued that accountants are asking to be shielded from the consequences of their mistakes. Professor Abraham Briloff, the Emanuel Saxe Distinguished Professor Emeritus of Accounting at Bernard M. Baruch College of the City University of New York described accountants as the "sentinel at the gates" of financial reporting:

> "[I]t is he who holds the passkey required for the history of the enterprise's management and accountability, its financial statements, to become acceptable for the purposes of the Securities laws. If he has been negligent in standing guard, if he has permitted the passkey to be used irresponsibly, then he should be held fully liable for any resultant harm to those who relied on his professional undertaking. To the extent he may identify those who overtly created the underlying quagmire, well, then, the auditor should have the right of subrogation. But again, as in negotiable instruments law, if you cannot find the 'maker', you proceed against the 'last endorser' -- in the circumstances before us that 'last endorser' is presumed to be the certified public accountant who had undertaken the independent audit function."[285]

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[282] Id., Hearing Record at 354.

[283] Id., Hearing Record at 352.

[284] Id., Hearing Record at 353.

[285] Prepared Statement of Professor Abraham J. Briloff, Hearing Record at 370.

Professor Briloff suggested that the accounting profession has not met its responsibility as "sentinel at the gate." He described a number of examples of failed audits or disingenuous audit ploys which he believed illustrated fundamental problems with the performance of the accounting profession. In particular, Professor Briloff was concerned about what he saw as the failure of the accounting profession to take strong steps to ensure that auditors were totally independent of their clients. For example, he criticized accounting firms for marketing non-audit management advisory services to the same clients for whom they perform audits.[286]

Professor Briloff also pointed to what he believed were the AICPA's ineffective efforts at disciplining accountants. He noted that AICPA disciplinary machinery only sanctioned approximately 40 accountants for ethical violations during 1992 and the first half of 1993, and that information on the firms that employ disciplined accountants is non-public.[287] He cautioned that the AICPA's recently announced intention to strengthen self-regulation should be viewed with skepticism. He pointed out that the AICPA made a similar pledge to toughen its disciplinary system in Congressional testimony made in 1978. The resulting new disciplinary bodies were intended to impose disciplinary sanctions on accounting firms as well as individuals. Briloff noted that in the ensuing fifteen years he has discovered only one disciplinary action against an accounting firm.[288]

Professor Briloff also dismissed the claim by the six largest accounting firms that litigation exposure was threatening their survival. Briloff accused the firms of using misleading figures in claiming that 14 per cent of auditing and accounting revenues were expended on litigation last year ($783 million expended out of $5.5 billion in revenues). Professor Briloff asserted that the six firms had a total domestic revenue of $12 billion in 1992, and worldwide revenue of $32 billion.[289]

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[286] Id., Hearing Record at 374. The significance of non-audit revenues to the six largest accounting firms is described at page 89 above.

[287] Id., Hearing Record at 378.

[288] Id., Hearing Record at 378-80.

[289] These figures are generally consistent with revenue estimates published in a professional accounting journal. See supra note 240, at 1. Based on these figures, Professor Briloff stated that

Melvyn I. Weiss also argued that the accounting profession has

"repeatedly failed to live up to its responsibilities. The litany of problems is familiar to every Member of this Committee: clean audit opinions routinely given to savings and loans shortly before the institutions became insolvent and had to be taken over by the federal government; certification of materially false and misleading financial statements; and an auditor-client revolving door fraught with conflicts of interest and self-dealing."[290]

"In order to get to the real figure you have to look behind the two-dimensional presentation. The key is in the phrase, "auditing and accounting" which does not include tax and consultative services and everything else those firms were engaged in for their revenues.

"We can anticipate ... [the claim] that the losses were essentially attributable to their audit services rather than the other areas of involvement. Aside from the fact that the losses were but 6.5 per cent of the $12 billion unitary pot, from which they were paid, it must be noted that the firms are disposed to "low balling the audit fees, subsidizing the audit as a 'loss leader.' It is the audit which regularly serves as the port of entry for the firm to expand its scope of activity -- and resultant fees, hence there is the process of reciprocity. Accordingly, to predicate the losses on the auditing and accounting sector alone is misleading."

Briloff statement, Hearing Record at 368-69.

[290] Weiss statement. Hearing Record at 400. According to Mr. Weiss, private civil liability is an important ingredient in ensuring that auditors properly perform their "watchdog" function. In his view, many other incentives exist to dampen the diligence of auditors:

"Corporate America is not run by shrinking violets. Senior management is characterized by people who are ambitious, strong willed, aggressive, frequently impatient, result-oriented, and often driven by a need for power, prestige and the acquisition of great wealth. Greed and avarice do very well in such an environment.

"The accountant/auditor is placed into this environment as a watchdog. But, auditors are not properly trained to carry out their safeguarding role. Auditors are trained to be accommodators and facilitators. Making waves aborts careers. Big accounting firms train their professionals to become partners within the firms or get jobs with their clients to protect the relationship in the future. Accountants on the staffs of big accounting firms who make waves do not get jobs in industry and do not rise in the hierarchy of their firms."

Responses of the SEC and other observers to accountants' concerns. The SEC noted in its testimony that the level of litigation against accountants may be attributable, at least in part, to the failure of accountants to meet public expectations. The SEC pointed out that "given the unprecedented level of financial fraud witnessed over the past decade, particularly in the banking and savings and loan sectors, the investing public and this Subcommittee have a legitimate right to ask why so many financial institutions failed shortly after receiving an unqualified audit opinion."[291]

The specific question of whether the accounting profession required some insulation from current liability standards in private securities actions was addressed by former SEC Chairman Richard C. Breeden. In response to an invitation to comment on proposed legislation which would have altered the current system in several respects, Chairman Breeden wrote that

> "there is justification for limiting [joint and several] liability for a defendant who does not knowingly engage in fraud and whose role in the wrongdoing is peripheral.... On the other hand, there may perhaps be cases where a defendant such as an auditor, while perhaps lacking 'knowledge' of the fraud, plays such an integral role in the perpetration of the fraud that he, rather than the innocent fraud victim, should bear the financial burden caused by the wrongdoing."[292]

Despite the concerns of the "Big Six" firms that litigation exposure drives them away from auditing "risky" clients, such as new high-technology companies, there are indications that auditors are able to accommodate litigation risk by adjusting their audit fees. An article by Professors Philip D. Drake and Randolph P. Beatty of Southern Methodist University studied 1,191 firms that completed initial public offerings ("IPOs") between 1982 and 1984 in order to determine the factors that influenced the amount charged by

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Weiss statement, Hearing Record at 405-06.

[291] McLucas statement, Hearing Record at 115.

[292] Letter from SEC Chairman Richard C. Breeden to Senator Pete V. Domenici , August 12, 1992, Hearing Record at 601.

auditors.[293] They found that auditors charged a higher audit fee for IPOs in which the issuer subsequently was delisted, went bankrupt, or was involved in a shareholder law suit. This indicated that auditors are able to charge a risk premium for IPOs that are likely to encounter difficulties.

b. Allocating Liability for Accountants

Leaders of the accounting profession argue that the liability doctrine of joint and several liability, defined and discussed at pages 120-130 below, has been particularly unfair for the accounting profession because it has exposed accounting firms to liability that is grossly disproportionate to their relative fault. Moreover, they contend that the role which independent auditors perform in the financial disclosure system regularly exposes accounting firms to the risk of massive liability. Unlike an issuer which is only responsible for offerings of its own securities, accounting firms provide services to numerous issuers.

Jake L. Netterville, Chairman of the AICPA, testified that the potentially huge exposures that accounting firms faced under joint and several liability forced them to settle cases even if they believed them to be without merit. "Today's prevailing doctrine of joint and several liability encourages plaintiffs -- even plaintiffs with weak cases -- to pursue claims against so-called 'deep pocket' defendants, because the threat of disproportionate liability and the cost of defense often coerce those defendants to settle. No pockets, however, are deep enough to sustain the magnitude of litigation that currently faces the accounting profession."[294]

As a response to the portion of the accounting profession's litigation exposure which arises under the federal securities laws, Netterville suggested that in cases where the accountant did not knowingly participate in fraud, joint and several liability should be replaced with a system of proportionate liability.

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[293] The authors noted that they selected initial public offerings as a study group because "[s]ince auditor compensation is a required disclosure in the IPO registration statement, survey response bias will not influence these tests. Also, the results indicate that IPO clients are more likely to exhibit financial distress than established clients. Since this research tests for effects of auditor legal liability (which is assumed to be a function of shareholder losses), the extraordinary concentration of financial distress among IPO firms is a desirable feature of this market." 31 J. of Accounting Research 294, at 300 (1993).

[294] Netterville statement, Hearing Record at 348.

Mr. Netterville's argument against joint and several liability in cases where the auditor did not knowingly engage in fraud was that "[a]ccountants should not pay for others' mistakes simply because they are the only ones left standing after a financial collapse. People should be held responsible only for the damage they cause; simple fairness and common sense demand it."[295]

Mr. Sommer also joined Netterville in his support for replacing the prevailing standard of joint and several liability with a system of proportionate liability, so that auditors are only held accountable for their own misdeeds, rather than the misdeeds of others. In addition to appealing to fairness, he believed that such a shift is justified by the possibility that one or more of the largest accounting firms could be bankrupted if it were subjected to paying all or most of a large judgment, Since accounting firms are organized as partnerships, with each partner personally liable for the debts of the firms, such a failure might have severe collateral consequences not only for the members of the firms who were personally blameless, but on the willingness of the surviving accounting firms to engage in further auditing work for companies or industries perceived to be litigation risks.[296]

Both Netterville and Sommer argued that one reason for the unfair operation of joint and several liability on accountants was the indeterminant standard of "recklessness" under which accountants can be found liable under the federal securities laws. For example, Mr. Netterville stated that "although the term 'recklessness' sounds like it encompasses only extreme misconduct, recklessness is in practice an ill-defined label that can be -- and often is -- erroneously applied to conduct that complies fully with applicable professional standards or amounts to at most bare negligence."[297] Their concern appears to stem from the nature of the audit function, which requires innumerable professional judgments. Their concern also appears to be based on the nature of the adjudicative function, particularly when juries are reviewing complex professional decisions.

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[295] Id., Hearing Record at 351.

[296] Because certain states prohibit accounting firms from incorporating, large national accounting firms have been unable to do so. Sommer recommended that Congress also enact legislation to override prohibitions that exist in some states against incorporation by accounting firms. Sommer statement, Hearing Record at 354.

[297] Letter from Jake L. Netterville to Senator Christopher J. Dodd, September 20, 1993, at 1.

The problem of distinguishing recklessness from instances of negligence or innocent mistake is compounded in cases against auditors because of the nature of the audit function. An audit requires a significant degree of estimation and professional judgment -- it is not simply a matter of adding up the numbers. As a consequence, it is all too easy for a plaintiffs' lawyer with 20-20 hindsight to identify good-faith estimates that turned out to be incorrect. When isolated, the lawyer can exploit these 'failures' of judgment and encourage a jury to label them recklessness.[298]

Responses of Critics. Professor Briloff strongly took issue with the arguments put forward by the accounting profession for curtailing joint and several liability. In Professor Briloff's view, "any relief from liability for professional malfeasance, misfeasance or nonfeasance should await a clear and compelling demonstration by my profession that the pervasive conditions have been corrected -- and not merely promises of a better tomorrow through a higher commitment."[299]

Melvyn I. Weiss also registered strong opposition to any curtailment of joint and several liability. Like Professor Briloff, Weiss believed that such a curtailment would unduly shield accountants from liability. Mr. Weiss also raised an argument against the proposal by the AICPA and others that joint and several liability be curtailed in cases in which the auditor did not knowingly participate in a fraud. Weiss warned that such a curtailment would "create an environment where conscious avoidance by the auditors would be the best course of conduct. Because if a jury looks at an active versus a passive onlooker who was reckless in not calling it to somebody's attention, we as trial lawyers know what the result is.... So what we are doing is we are creating an incentive for the auditor not to do his watchdog job."[300]

Responses of Other Observers. The SEC also expressed reservations about proposals to curtail joint and several liability.

"It is especially important to recognize that certain of the proposals included under the rubric 'litigation reform,' such as proportionate

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[298] Id. at 4.

[299] Briloff statement, Hearing Record at 368.

[300] Hearing Record at 336-37.

liability or changes in the standards for aiding and abetting liability, go far beyond other measures that would affect only baseless claims. Such proposals would fundamentally alter private securities fraud litigation by changing either the standard for secondary liability, or the consequences of such liability. If enacted, these proposals could make it impossible for defrauded investors who prevail at trial to recover full compensation for their losses."[301]

The SEC suggested that "[b]efore concluding that public expectations need to be lowered, or that liability standards need to be raised, it is important to consider ways to improve auditing standards and accounting principles."[302] Beyond this, the SEC suggested that "as between innocent investors who have been defrauded and professional advisers who have access to information within the company and and have knowingly or recklessly assisted the fraud by failing to meet professional standards, the risk of financial loss under the current system falls on the latter."[303]

3. Conclusions on Accountants' Liability Concerns.

The information provided to the Subcommittee by the accounting profession and others indicates that accounting firms currently face substantial and growing liability exposure under both state and federal law. This growth can be explained by four factors: (i) audit failures -- particularly in connection with the savings and loan industry; (ii) the inability of the profession to bridge the "expectation gap" between what it views as its responsibility and what the public expects; (iii) the availability of accounting firms as "deep pockets" when other parties are less solvent; and (iv) frivolous litigation. Since most of the payouts by the major auditing firms arise in settlements, one can only speculate on the role of each of these factors in the rise in liability exposure. If the rise in exposure can be attributed entirely to a pattern of audit failures or the "expectation gap" the profession is paying for its own shortcomings.[304]

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[301] McLucas statement, Hearing Record at 112.

[302] Id., Hearing Record at 115.

[303] Id., Hearing Record at 118.

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"The profession often has expressed the view that investors expect too much from the audit function, and that auditors are blamed for failing to detect financial fraud even when they meet relevant professional standards. Nevertheless, given

If the rise is driven solely by "deep pockets" or coercive settlement of weak cases, the rise in exposure is unjustifiable.

However, the critical issue is whether the current system of disciplining auditors of public companies -- a weak system of regulation through voluntary organizations combined with significant civil liability exposure -- is sound public policy. It is difficult to reconcile the assertions of some who defend the current liability system that, on one hand, the current liability system "has worked well" and has "played a substantial role in assuring that the United States has the most vibrant securities markets in the world" and that, on the other hand "the [accounting] profession over the years has repeatedly failed to live up to its responsibilities."[305] ***The evidence suggests that the current liability scheme in place over the past decades has not prevented significant audit failures.*** This may be because neither the current professional disciplinary mechanisms nor the private civil liability system provide sufficiently strong personal accountability for individual auditors within large accounting firms.

A number of the concerns expressed by the accounting profession reflect the uncertainty surrounding evolving legal standards, and may be addressed by the courts. For example, concerns about uncertainties surrounding the elements for aiding and abetting violations of the securities laws were recently obviated by the decision of the Supreme Court in the Central Bank case discussed at page 6 above, which eliminated private aiding and abetting liability entirely in cases brought under Section 10(b) of the Exchange Act.

The impact that these levels of liability exposure might have on incentives for the accounting profession to perform future public audits is troubling. Warnings by the profession that major accounting firms may pull back from auditing newer companies, or may charge substantial risk premiums for such audits, could have serious implications for the ability of such companies to gain access to the capital markets. This in turn could hurt job creation or the ability of certain industries to compete in global markets.

> the unprecedented level of financial fraud witnessed over the past decade, particularly in the banking and savings and loan sectors, the investing public and this Subcommittee have a legitimate right to ask why so many financial institutions failed shortly after receiving an unqualified audit opinion."

McLucas statement, Hearing Record at 115.

[305] Weiss Statement, Hearing Record at 400.

Accountants' concern about this exposure is magnified by the fact that accounting firms are organized as partnerships, creating the possibility of unlimited personal liability for each partner. The impact of joint and several liability under the federal securities laws, and punitive damages in malpractice actions under some state laws, heightens this concern. However, it appears that the Supreme Court's recent Central Bank of Denver decision, discussed at page 6 above, may have significantly alleviated accountants' level of exposure under the federal securities laws.[306]

It would be desirable to address the apparent lack of an effective self-disciplinary process within the profession to deal with improper or inadequate audit work in connection with the liability concerns of accountants. Without more meaningful self-discipline, the threat of substantial civil liability may be important to ensuring that auditors diligently fulfill their role as "public watchdogs" rather than yield to pressure to accommodate their clients.

Representatives of the accounting profession have pointed to two general areas in which the profession could be improved: (i) strengthening the public auditing function by curtailing joint and several liability, to avoid the risk that open-ended liability might drive accounting firms away from providing auditing services to public companies;[307] and (ii) enhancing public confidence in the profession through a stronger system of self-discipline, and through clarifying the obligation of accountants to search for fraud. Those proposals are discussed below.

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[306] The extent to which that decision impacted on accountants' exposure is a subject of ongoing study by the Subcommittee staff.

[307] As noted above, the Subcommittee staff is studying the extent to which the recent Central Bank of Denver decision may have effectively answered accountants' concerns about excessive liability exposure under the federal securities laws.

B. PROPOSALS TO REFORM JOINT AND SEVERAL LIABILITY AND CONTRIBUTION

Joint and several liability is the common law doctrine that holds each tortfeasor separately and personally liable for all damages arising from an injury where the harm to the victim is indivisible, even though the injury results from the tortious acts of more than one tortfeasor.[308] A victim's collective recovery from all of the tortfeasors, however, cannot exceed the damages he or she has sustained from the injury and each tortfeasor may typically seek contribution from the other tortfeasors for liability in excess of that tortfeasor's proportionate share based on fault.

The principle of contribution has a significant effect in federal securities law actions in determining how liability is apportioned among defendants. Under the equitable doctrine of contribution, a defendant may seek reimbursement from other persons who are jointly liable with him for a victim's injury to recover any payment to the plaintiff in discharge of liability in excess of his share of the joint liability. Contribution affects the apportionment of liability not only as to final judgments, but also in settlements, including partial settlements in which some defendants settle while others go to trial.

Certain express private rights of action under the federal securities laws explicitly provide for contribution, while others do not. The Supreme Court recently held that a right of contribution exists in implied rights of action.[309] Under the federal securities laws, courts have employed the doctrine of joint and several liability, together with the equitable doctrine of contribution, to allocate liability among co-defendants. However, several significant anomalies currently exist in the application of joint and several liability and contribution in federal securities law actions.

1. Apportionment of Liability According to Fault.

The method of apportioning liability among contributing defendants is an unsettled issue. In most jurisdictions, liability is apportioned according to relative fault among the defendants. For example, take a case in which a company with publicly traded stock and its outside auditor are liable to the plaintiff for a $10 million anti-fraud judgment, and the issuer is determined by

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[308] See Speiser, Krause & Gans, The Law of Torts § 3.6.

[309] Musick, Peeler & Garrett v. Employers Insurance of Wausau, 113 S.Ct. 2085 (1993).

the court to bear 80 per cent of the fault while the auditor bears 20 per cent of the fault. If the plaintiff seeks to enforce the judgment against the auditor, that defendant would be entitled to seek contribution of $8 million from the issuer. This departs from the alternative pro rata approach, under which liability is equally divided among the defendants, so that the auditor who was 20 per cent at fault would only be able to recover $5 million from the issuer.

The pro rata approach was the prevailing rule at the time the securities laws were adopted, and it is still good law in the Second and Fourth circuits.[310] In contrast, most courts that have considered the question in recent years have decided against the use of the pro rata measure.[311] The pro rata approach was traditionally favored because it was easier for courts to administer, since it did not require the court to determine relative fault. However, this administrative convenience appears to be minimal, since the court must make a determination of whether the defendants are liable in any event. The additional step of determining relative fault may be a marginal additional burden, especially in light of the inequity of dividing liability equally among multiple defendants who may often have vast gradations of culpability. In sum, the pro rata standard may have "more mathematical than judicial integrity."[312]

2. Apportionment of Liability of Non-Settling Defendants.

A second difficulty has concerned the apportionment of liability among defendants where some, but not all, defendants choose to settle. Contribution principles affect the bargaining process of both defendants and plaintiffs.

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[310] See, e.g. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 39 (2d Cir. 1976); Globus, Inc. v. Law Research Service, 318 F. Supp. 955 (S.D.N.Y. 1970), aff'd, 442 F.2d 1346 (2d Cir.), cert. denied, 404 U.S. 941; Wassel v. Eglowsky, 399 F. Supp. 1330, 1370-71 (D. Md. 1975), aff'd, 542 F.2d 1235 (4th Cir. 1976). See also Ruder, Multiple Defendants in Securities Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 650 (1972); Smith v. Mulvaney, 827 F.2d 558, 560-61 (9th Cir. 1987) (adopting relative fault approach but discussing conflicting authority).

[311] See McLean v. Alexander, 449 F. Supp. 1251, 1272-77 (D.Del. 1978), rev'd on other grounds, 599 F.2d 1190 (3d Cir. 1979); Gould v. American-Hawaiian Steamship Co., 387 F. Supp. 163, 171 (D.Del. 1974), vacated on other grounds, 535 F.2d 761 (3d Cir. 1976); Pepsico, Inc. v. Continental Casualty Co., 640 F. Supp. 656, 662 (S.D.N.Y. 1986).

[312] McLean v. Alexander, 449 F. Supp. 1251, 1273 (D. Del. 1978), rev'd on other grounds, 599 F.2d 1190 (3d Cir. 1979).

Settling defendants will often seek a settlement bar order in connection with a partial settlement to preclude non-settling defendants from subsequently asserting claims for contribution against the settling defendants.[313] Such relief may be entered in return for a reduction in the amount of the judgment that can be sought against the non-settling defendants. In such circumstances, courts have sharply split over the issue of how any resulting judgment should be reduced.

One approach favors a reduction rule that reduces the judgment in proportion to the settling defendant's fault. If in the example given above the defendant who was 80 per cent at fault settled, the potential judgment against the non-settling defendant would be reduced from $10 million to $2 million, regardless of the amount of the settlement. The other approach is to reduce the judgment on a pro tanto basis, dollar for dollar, based on the amount of the settlement payment. Under such a rule, if the 80 per cent liable defendant in the example settled by paying $3 million, the remaining defendant would be potentially liable for $7 million of the $10 million in damages, even though only 20 per cent at fault.

There are difficult policy considerations in choosing from among the proportionate basis and the pro tanto basis for offsetting settlements from liability. The proportionate approach is more fair to defendants who do not settle. On the other hand, the pro tanto approach may further the general policy of encouraging settlement because it does not expose a plaintiff to the risk of a "cheap settlement", i.e., that if the plaintiff settles with one or more parties early in the litigation, before plaintiff has obtained better information about the case through civil discovery, the plaintiff might risk losing a substantial portion of its monetary claim if the evidence shows that the settling defendant's responsibility for the violation was greater than the plaintiff had thought. The pro tanto approach may also be easier for courts to administer, since it avoids the need for the court to determine the relative fault of parties who are no longer in the case. It might be difficult for a court to make such a determination if a settling co-defendant is no longer available to testify.

A recent Supreme Court decision sheds some light on the policy choice. In McDermott, Inc. v. AmClyde, the Court unanimously held in a case brought under admiralty law that the liability of nonsettling defendants should be

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[313] Even in the absence of such an order, courts may bar a contribution claim against a settling defendant. See Franklin v. Kaypro, 884 F.2d 1222 (9th Cir. 1989); Singer v. Olympia Brewing Co., 878 F.2d 596 (2d Cir. 1989).

calculated with reference to the jury's allocation of proportionate responsibility among the parties at fault. The court observed that there is "a divergence among respected scholars and judges about how [settlement payment] credit should be determined."[314] There were three choices available to the Court: a pro tanto rule with a right of contribution by the nonsettling defendant against the settling defendant; a pro tanto rule without a right of contribution; and a reduction of the judgment against the nonsettling defendant to reflect the proportionate fault of the settling defendants. The court noted that "pro tanto setoff with right of contribution is clearly inferior... because it discourages settlement and leads to unnecessary ancillary litigation."[315] However, "[t]he choice between ... the pro tanto rule without contribution against the settling defendant and the proportionate approach is less clear."[316] The court noted that the pro tanto approach should necessitate having the court conduct a hearing to ensure that the settlement was entered into in good faith, and does not unfairly disadvantage the nonsettling party. The court concluded that the proportionate approach promoted settlement and judicial economy better than the pro tanto approach "although the arguments for the two approaches are closely matched."[317]

The proportionate approach appears preferable to the pro tanto approach for at least two reasons. First, the reasoning of McDermott supports the proportionate approach. Since there is a right of contribution under the federal securities laws, the pro tanto choice in securities law cases is the one the Court unanimously found "clearly inferior." Second, as discussed above, courts should make determinations of relative fault in all securities law cases involving violations which may have been caused by more than one person, so that contribution claims can ensure that liability is fairly apportioned among the responsible parties. That determination can be made even if a co-defendant is no longer in the case, because incentives will still exist in the adversarial system to contest the degree of fault of settling defendants. The remaining defendants will obviously have an incentive to seek to prove a high level of culpability of defendants who have settled, while plaintiffs will have an incentive to prove a high level of culpability by the remaining defendants.

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[314] McDermott, Inc. v. Amclyde and River Don Castings, Ltd., 62 U.S.L.W. 4241; 1194 U.S. LEXIS 3122, at 11 (April 20, 1994).

[315] Id. at 18.

[316] Id. at 20.

[317] Id. at 29.

3. Insolvent Co-Defendants.

Finally, under joint and several liability if one of the defendants is insolvent, the co-defendants are liable for his portion of the liability as well as their own. This rule has had significant consequences for peripheral defendants, at least as applied prior to the recent Supreme Court decision in Central Bank of Denver.[318] An illustration would be a case in which the issuer commits a fraud while its auditors and/or attorneys assist the fraud by engaging in conduct a court would consider to be "reckless."[319] If the issuer becomes insolvent once the fraud comes to light, these parties who were not the knowing perpetrators of the fraud could be liable as aiders and abettors for all of the resulting damages to investors.

An alternative to joint and several liability is proportionate liability, or liability apportioned according to each defendant's comparative fault.[320] Joint and several liability, coupled with equitable contribution based on relative fault, achieves the same result as proportionate liability in cases in which all

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[318] For a discussion of this case, see page 6 above. The precise impact of this decision on accountants and lawyers whose clients engage in wrongdoing is not yet clear.

[319] A number of federal courts have held that recklessness is the minimal level of intent necessary to satisfy the "scienter" requirement for anti-fraud actions under Section 10(b) of the Exchange Act. See e.g., Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 46-47 (2d Cir.), cert. denied, 439 U.S. 1039 (1978); Broad v. Rockwell International Corp., 642 F.2d 929, 961-62 (5th Cir.) (en banc), cert. denied, 454 U.S. 965 (1981); Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1044 (7th Cir.), cert. denied, 434 U.S. 875 (1977). The Sundstrand decision provided a widely cited definition of recklessness as

> "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or seller that is either known to the defendant or is so obvious that the actor must have been aware of it."

Id. at 1047. See Hollinger v. Titan Capital Corp. 914 F.2d 1564, 1569 & n. 8 (9th Cir. 1990 (en banc) (citing cases that follow Sundstrand definition), cert. denied, 111 S.Ct. 1621 (1991).

[320] Proportionate liability is often designated "several" liability. The term "proportionate liability" is used here to avoid confusion with joint and several liability.

defendants are solvent and joined in the same action.[321] The two methods diverge, however, when one or more defendants is insolvent. Under "strict" proportionate liability, each tortfeasor remains liable only for his or her proportional share of the liability, while joint and several liability requires that solvent tortfeasors make each plaintiff whole. In effect, proportionate liability shifts the risk of the insolvent defendant's unfunded liability onto the shoulders of the plaintiff, while joint and several liability shifts that risk onto the remaining solvent defendants.

Proponents of joint and several liability frame the policy choice in terms of whether the innocent plaintiff or a culpable defendant should bear the risk of loss if a co-defendant is insolvent. If the solvent defendant does not bear such costs, the plaintiff must, by default. They suggest that it is fairer, in view of the solvent defendant's participation in causing the plaintiff's injury, for the solvent defendant to bear the liability of the insolvent defendant. Another argument by proponents of joint and several liability is that such liability provides a useful deterrent against violating the securities laws.

Another view is that while the potential for such disproportionate liability may deter some wrongdoing, it also deters potential deep-pocket defendants from offering products or services. Under this analysis, the need to compensate injured plaintiffs alone cannot justify imposing additional liability on solvent defendants if it threatens the future availability of services offered for the benefit of investors. This position holds that, just as solvent defendants would not be liable for a separate injury suffered by a plaintiff, the solvent defendant should not be liable for damages arising from that portion of the injury in excess of his or her own fault. Critics of joint and several liability also contend that it is especially unfair to make peripheral deep pocket defendants consistently liable for torts principally attributable to another party.

Some additional policy issues also arise in the particular context of the securities laws. For instance, joint and several liability may promote a market monitoring function, by creating incentives for accountants to exercise vigilance in looking for fraud before certifying financial statements, or for lawyers or underwriters to exercise diligence in ensuring that offering materials are not misleading. On the other hand, the incentives to avoid joint and several liability may be very weak for any given partner of a law firm or accounting

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[321] See Wright, Allocating Liability Among Multiple Responsible Causes: A Principled Defense of Joint and Several Liability for Actual Harm and Risk Exposure, 21 U. Cal. Davis L. Rev. 1141 (1988).

firm with hundreds or thousands of partners available to absorb the potential liability.

4. **Alternative Approaches to Joint and Several Liability.**

Joint and several liability has been the traditional rule in most state tort actions. However, in recent decades about 35 states have modified joint and several liability to varying degrees, primarily in personal injury cases involving negligence and other fault-based torts. Eleven of these states have eliminated joint and several liability for substantial classes of cases.[322] Twenty-four states have moved toward various hybrids of joint and several liability and proportionate liability.[323] For example, some states impose proportionate liability only if a defendant's relative fault is below a specified threshold,[324] and some states cap liability for any defendant at some multiple of its proportionate liability.[325] Several states also apply proportionate liability only for non-economic damages.[326]

Since most states which have adopted forms of proportionate liability have only done so for personal injury cases, which typically involve a lower standard of liability than under the federal securities laws, their approaches are not directly analogous to the arguments for proportionate liability.

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[322] These states are Alaska, Arizona, Colorado, Idaho, Kansas, Nevada, New Mexico, North Dakota, Utah, Vermont and Wyoming. Several of these states continue to apply joint and several liability to intentional torts or business torts. See, e.g., Ariz. Rev. Stat. Ann. §12-2506 (Supp. 1993); Idaho Code §6-803(3) (1990); Nev. Rev. Stat. §41.141 (1991); N.M. Stat. Ann. §41-3A-1 (1991); N.D. Cent. Code §§32-03.2-02 to -03 (Supp. 1993).

[323] These states are California, Connecticut, Florida, Georgia, Hawaii, Illinois, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New York, Ohio, Oregon, South Dakota, Texas, West Virginia and Washington.

[324] See, e.g., Iowa Code Ann. § 668.4 (West 1987)(proportionate liability for defendants less than 50 per cent responsible); Or. Rev. Stat. § 18.485 (1989)(less than 15 per cent); W. Va. Code §29-12A-7(1991)(less than 25 per cent).

[325] See, e.g. Minn. Stat. Ann. § 604.02 (West 1988 & Supp. 1993) (defendant less than 15 per cent responsible can be liable for up to four times responsibility); S.D. Codified Laws Ann. §§ 15-8-15.1 to .2 (Supp. 1993)(defendant less than 50 per cent responsible can be liable for up to twice responsibility).

[326] See, e.g. Cal. Civ. Code §§ 1431.2 (West Supp. 1993); Conn. Gen. Stat. §52-572h (1991); N.Y. Civ. Prac. L. & R. § 1601 (McKinney Supp. 1993).

However, the approaches taken by some states might be a starting point to possible structures for proportionate liability under the federal securities laws. Examples from just a few of the many approaches taken by states helps to illustrate the range of possibilities.

To illustrate, take a situation in which liability for a $10 million judgment has been apportioned among three defendants so that A, the primary violator, is 60 per cent liable, while B and C, whose involvement in the wrongdoing was more peripheral, are liable for 30 per cent and 10 per cent respectively. Before the judgment was collected, A was discovered to be insolvent.

- Under "strict" proportionate liability, B and C would be obligated to pay no more than $3 million and $1 million respectively, and plaintiffs would not be able to collect the portion of the judgment attributable to A.

- Following an approach similar to the one taken by Michigan, modelled on the Uniform Comparative Fault Act, plaintiffs could petition the court within six months after a final judgment to reallocate any uncollectible amount among the other parties. However, a party could not be required to pay a percentage of any uncollectible amount which exceeds its percentage of fault. Under the example above, if A is insolvent, the court could reallocate the liability so that B and C, in addition to paying for the portion of the liability for which they are responsible, would also pay the portion of A's liability that corresponds to their proportionate fault. In this example, B would be liable for a total of $5.1 million ($3 million plus 30 per cent of A's $7 million liability) and C would be liable for $1.7 million ($1 million plus 10 per cent of A's liability).[327]

- Following an approach similar to the one taken by Illinois, plaintiffs could only collect the proportional amount of liability from a defendant who is less than 25 per cent liable, but a defendant more than 25 per cent liable would be jointly and severally liable. Thus, in the example above, C would be only liable for its $1 million proportionate share, while B

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[327] See Mich. Comp. Laws § 27A.6304 (1993) (cum. supplement), Uniform Comparative Fault Act § 2(d) (1977). Michigan's approach applies only to personal injury cases.

would be liable for $9 million, representing its own share plus A's full share.[328]

5. **Conclusions**.

Several changes appear to be warranted in the manner in which liability for securities law violations is apportioned. First, for the reasons discussed at page 121 above, liability among defendants should be apportioned according to the defendants' relative fault, rather than on a pro rata basis. Second, for the reasons discussed at page 123 above, when cases are partially settled, the judgment against non-settling defendants should be reduced to reflect the relative fault of the settling defendant, rather than simply reducing the judgment by the amount paid in settlement. Legislation in these areas would codify what is already the prevalent rule in most jurisdictions, and would lead to nationwide consistency and predictability on these important questions.

Finally, some modification of joint and several liability appears to be justified. The two principal arguments made by proponents in favor of joint and several liability have potential flaws. The first argument, that private joint and several liability effectively disciplines accountants and other professionals, is to some extent self-impeaching since it is propounded by some who simultaneously assert that the performance of the accounting profession is poor and getting worse.[329] In addition, this reasoning assumes that exposing accountants to higher levels of liability necessarily leads to better auditing.[330] Representatives of the accounting profession, such as Netterville and Sommer, deny that enhancing liability for accounting firms has this effect. They suggest that higher levels of liability lead to withdrawal of audit services rather than better audits. This view is supported by the analysis of one scholar concerning a comparable issue, the effect of increased liability for

[328] Ill. Rev. Stat. ch. 735, ¶5/2-1117 (1993). However, Illinois limits proportionate liability to non-medical expenses in personal injury and product liability cases. All defendants are still jointly and severally for medical expenses.

[329] See Weiss Statement, Hearing Record at 400.

[330] A similar line of reasoning has been followed by some courts to support discarding the Ultramares privity doctrine in negligence cases under state law. See Rosenblum, Inc. v. Adler, 93 N.J. 324, 350 (1983)(exposing accounting firms to greater liability should "cause accounting firms to engage in more thorough reviews." But see Siliciano, supra note 235, at 1940, 1959-61 (questioning Rosenblum's assumption).

accountants under the laws of states which have relaxed the Ultramares privity doctrine.

> "Rather than simply vowing to audit more vigorously, the profession has consciously devised a number of strategies for limiting liability exposure through means other than increasing the level of care. Thus, in response to the threat of increased liability... audits may become unavailable to enterprises in an early growth phase, where audit risks are generally highest."[331]

The second argument, that joint and several liability for accountants fairly places economic loss on solvent defendants rather than innocent investors, may take a somewhat narrow view of shareholder welfare. It does not address the likelihood that accountants and other professionals will transfer some or all of their liability risk elsewhere. As discussed at pages 113-14 above, studies have shown that the risk of liability exposure faced by accountants is likely to result in higher audit charges to companies receiving public audits. This cost is ultimately borne by shareholders (and consumers). Consequently, much of the economic loss which joint and several liability places on the shoulders of auditors rather than defrauded investors is ultimately dispersed among the investing public. It is somewhat different to say that the investing public should bear a substantial part of the loss incurred by defrauded investors than it is to say that reckless accountants, not innocent investors, should pay for the injury incurred by a securities fraud.

In addition, the trend in state law toward various forms of proportionate liability in actions involving negligence reflects a judgment by many legislatures that the relative fault of defendants deserves consideration in fixing liability. ***This trend reflects an emerging policy consensus that some limitations on joint and several liability are justified to ameliorate the consequences where liability is widely disproportionate to relative fault, and where liability does not involve a high degree of culpability, so that the civil liability system is more consistent with the***

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[331] Siliciano, supra note 235, at 1959-60. Siliciano offers this explanation for why accountants would react this way:

> "Faced with the prospect of a reckless client, a limited technology [for ascertaining the truth about a client's financial condition], and an error-prone adjudicative process, the profession might reasonably view the enhanced liability of the reform courts simply as a tax on the activity of accounting." Id. at 1962.

relative fault of co-defendants. However, this consensus at the state level does not extend to defendants who acted with a high degree of culpability. Policy concerns about deterring bad conduct and making plaintiffs whole are more compelling when considering defendants whose involvement in the alleged wrongdoing is more direct. Joint and several liability, rather than proportionate liability, appears to be appropriate for defendants (including accountants) who are closely associated with the wrongdoing.

In addition, relative culpability may not always be the only appropriate indicator of responsibility in the case of egregious securities fraud. For example, an issuer may perpetrate a knowing fraud, while the issuer's agents, such as its independent auditors or law firm or financial adviser may contribute to the harm through less egregious conduct. Although the conduct of the agents may be less blameworthy than that of the primary violator, the agent's responsibility for harm to investors may nonetheless be considerable. The market may place far greater reliance on the judgment of an independent auditor, law firm, or investment bank than on the issuer, and the agent's actions may be more critical in causing injury to investors. ***Any attempt to fashion a system of proportionate liability should therefore consider both a defendant's degree of culpability and the causal connection between the defendant's role and the harm caused.***

To ensure that the accounting profession performs as a diligent "public watchdog," it may be desirable to couple a system of proportionate liability with provisions to ensure that accountants who fail in that role are subject to direct and swift discipline. Issues pertaining to such a disciplinary system are discussed below.

C. <u>Need for SRO for Auditors</u>.

Any reform of the securities litigation system as it applies to auditors should also reflect the critical role that the independent audit function plays in capital formation, and the heavy reliance which investors and creditors place on the accuracy of audited financial statements. As discussed above, one of the concerns expressed by many observers about curtailing joint and several liability for accountants is the role that this form of liability plays in the absence of other means of ensuring that auditors perform their role with diligence. Any significant alteration of joint and several liability as it affects accounting firms should be accompanied by other steps to strengthen the profession's ability to discipline itself. Any adjustments that are made should also take into consideration the significant role that auditors play in enhancing

investor confidence. The net effect of any reforms should be to enhance rather than diminish incentives for auditors to adhere to generally accepted accounting principles and generally accepted auditing standards.

One approach to accomplishing this goal would be to establish a self-regulatory organization for accountants, subject to direct review by the SEC, to bolster public confidence concerning the professional standards of accountants. The overall result should be a regulatory and liability regime which is more fair, and which enhances public confidence in financial reporting.

Self-regulatory organizations have a long lineage under the federal securities laws in other areas. For example, securities brokers and dealers are required to belong to the NASD, which directly regulates trading practices, customer complaints and similar matters. Securities exchanges such as the New York Stock Exchange, the American Stock Exchange and the Pacific Stock Exchange provide similar direct oversight of their members. All of these organizations have authority to promulgate rules setting standards for their members, and all have authority to investigate and discipline members, through fines, censure, expulsion and other measures. Another approach to self-regulation is exemplified by the Municipal Securities Rulemaking Board, which has authority to prescribe rules for municipal securities dealers, subject to SEC approval, while enforcement authority resides only with the SEC and other government agencies.

These and other self-regulatory organizations are subject to a wide range of different structures in their governing boards, typically involving a balance between board members selected by members and board members selected by the existing board, as well as varying degrees of financial independence between board members and the group regulated by the organization. Operating expenses of self-regulatory organizations are also typically funded by fees paid by their members. This approach to regulation, although subject to criticism in many details, has generally been viewed as a fairly successful approach. As this Committee noted in its report accompanying the Securities Acts Amendments of 1975, "[t]he self-regulatory roles of the exchanges and the NASD have been major elements of the regulatory scheme of the Exchange Act since 1934 and 1938, respectively. Although self-regulation has not always performed up to expectations, on the whole it has worked well, and the Committee believes it should be preserved and strengthened."[332]

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[332] Senate Report No. 94-75, 1 U.S. Code Cong. & Ad. News 179, 201 (1975).

Moss Bill Calls for some type of self-regulatory organization have come from a wide range of observers of the accounting profession. For example, in 1978 Congressman Moss, the Chairman of what is now the Energy and Commerce Committee of the House of Representatives, introduced the "Public Accounting Regulatory Act," which called for a National Organization of Securities and Exchange Commission Accountancy ("Organization").[333] That body would be headed by a five-member board, initially appointed by the SEC, with succeeding members appointed by the board from a list of candidates supplied by the SEC. Two members of the board could be from accounting firms regulated by the Organization and three would be unaffiliated with such firms. The bill required all public accounting firms and their principals to register with the Organization in order to provide audit reports in connection with the federal securities laws.

Under the bill, the Organization would review particular audits by each firm at least every three years looking for possible violations of professional standards, would investigate possible conflicts between audit services and non-audit services performed for the same client, and could impose a broad array of sanctions on firms or individuals who were found to violate professional standards.[334] The Organization's disciplinary sanctions would be made public and reported to the SEC, which could review its actions. The bill also directed that the SEC, in conjunction with other organizations or on its own authority, develop and issue appropriate auditing standards and quality control standards for accountants who prepare audit reports filed with the SEC.[335]

Other Proposals for Self-Regulation Although the Moss bill was not enacted, calls for enhanced self-regulation have surfaced from a wide range of other sources, from critical observers of the profession to at least one major accounting firm and the AICPA. For example, Professor Briloff has written

> "[T]he Big Eight's oligopolistic hold on the AICPA must be broken in the profession's disciplinary and self-regulatory proceedings.... To remedy this condition I urge the establishment of an independent disciplinary apparatus, adequately funded and fully staffed. Such an independent

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[333] H.R. 13175, 95th Cong., 2d Sess. (1978). The initial co-sponsors of the bill were Congressmen Waxman, Walgren, Gore and Moffett.

[334] H.R. 13175, § 5.

[335] H.R.13175, §7(b)(3).

board would be expected to take notice, either on its own initiative or by referral from members of the profession or others, of deviations from the established standards of conduct. I would expect such a board to proceed with its inquiry and judgment independent of (and probably also in advance of) any other proceedings before the courts and/or regulatory agencies."[336]

In a 1985 report, Price Waterhouse, one of the six largest accounting firms, also advocated establishing an independent self-regulatory organization somewhat resembling the body suggested by Professor Briloff, although with some significant differences. The report began by noting the impact that a few audit failures have had on investor confidence and capital formation:

> "[I]n the early 1980s there began a succession of spectacular business and financial institution failures. Not only stockholders but large and small depositors and all those engaged in investment transactions with failed banks, savings and loan associations, and government securities dealers became victims of the financial fallout. The failures may have been caused by poor management, fraud, changed economic circumstances, or a combination of all of these. In any event, in the public's judgment the auditors should have known what was going on. Thus, fairly or unfairly, the business failures have in the public's eyes become audit failures....
>
> "What is expected of the profession's overall performance might be compared to what is expected of its audit performance. A 99.8 per cent audit success rate over five years is not bad, but the exceptions have been costly to investors, the public, and auditors themselves. Despite an outstanding record, the profession must strive for zero audit failures.
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> "Obviously, zero audit failure and perfect performance are unattainable. But they are the targets to shoot for. It must be

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[336] Abraham J. Briloff, More Debits than Credits: The Burnt Investor's Guide to Financial Statements 422 (1977). In subsequent communications with the Subcommittee staff, Professor Briloff has argued that creation of a self-regulatory organization for accountants would not warrant any relief from liability exposure, and has expressed concern that certain proposals for a self-regulatory organization might be ineffective and detrimental to the professionalism of accountants.

recognized that headline-making exceptions to the generally sound record of the profession's achievement cast doubt on all our efforts."[337]

The report suggested that the function of the SEC Practice Section should be adopted by this entity, and that it should have these statutory features:

"• Participation should be mandatory for all firms or sole practitioners that audit SEC registrants.

• The new SRO should have credible rule-making and disciplinary powers.

• Members of the organization's initial governing board should be appointed by the SEC, and succeeding members should be elected by the governing board subject to SEC approval.

• There would be more structured oversight by the SEC of SRO rule-making, disciplinary procedures, membership, and administration....

"In response to the public's particular concerns, it should be explicitly noted that, as is the case with the SEC Practice Section, the proposed SRO will have the jurisdiction to interpret matters relating to auditor independence, including the question of the impact of the provision of consulting services to SEC registrants by their auditors....

"The SRO should also have certain clearly defined limitations:

• The scope of SRO and thus SEC authority would be confined to broad issues of quality control, and would not extend to the discipline of individuals. Such discipline would continue to rest with other appropriate authorities, such as state licensing authorities.

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[337] Price Waterhouse Report, <u>supra</u> note 246, at 5-6.The report recommended a number of reforms beyond a self-regulatory organization, including greater audit attention to management controls, steps to look for possible management fraud and liability relief at the state and federal level.

- Sanctions by the SRO should not serve as a basis for SEC Rule 2(e) disciplinary proceedings.

- The licensing and regulatory authority of state boards of accountancy should not be preempted.

- The SRO should not have auditing or accounting standard-setting authority. Such authority would remain with the Auditing Standards Board and the Financial Accounting Standards Board, respectively."[338]

The AICPA has also recently indicated general support for a self-regulatory organization:

> "The effectiveness of the accounting profession in governing itself and disciplining its members is essential to public confidence in the financial reporting system. That there be not doubt in the public mind of the profession's commitment to punishing wrongdoers in its ranks, we recommend a strengthened system to discipline those guilty of substandard work or professional misconduct -- individual CPAs as well as firms There is no room in our profession for 'bad apples.' This system should reside in the profession with oversight by the government and should be national in scope. It should apply to auditors of SEC-registered companies and other publicly accountable entities....
>
> "We propose a system under which investigative and disciplinary proceedings would take place regardless of whether legal proceedings were also under way. Accountants would know that their profession will respond swiftly to any alleged misconduct or substandard performance."[339]

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[338] Price Waterhouse report, <u>supra</u> note 246, at 12-13. The report also "state[d] most emphatically that our support for an SRO is conditioned on the maintenance of confidentiality of specific audit engagements to preclude SEC access to specific client information." <u>Id</u>. at 14.

[339] American Institute of Public Accountants, <u>Meeting the Financial Reporting Needs of the Future: A Public Commitment From the Public Accounting Profession</u>. The AICPA also proposed that "[i]nformation gathered and findings reached by the disciplinary structure should not be admissible in civil proceedings" and that "a way must be found to eliminate parallel, sequential or multiple investigations and proceedings." <u>Id</u>. at 6.

In contrast to the position taken by the AICPA, the Public Oversight Board of the AICPA has expressed opposition to the creation of a self-regulatory organization. The Board has suggested that disciplinary organizations such as the NASD are inapposite because issues involved in broker-customer disputes are usually far easier to investigate and resolve than questions about possible audit failures.[340] The Board has also considered establishment of a government body analogous to the National Transportation Safety Board, an independent federal agency that determines the "probable cause" of transportation accidents and issues safety recommendations based on those studies. The Board concluded that establishment of such an organization would not be necessary or desirable,[341] but that the QCIC's objectives could

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"The typical NASD proceeding takes a few hours and rarely do the proceedings last longer than a day. Generally, the issues are fairly simple.... There is rarely , if ever, a need to secure records in the possession of third parities or the testimony of others....

"An adequate inquiry into an alleged audit failure, on the other hand, entails the examination of masses of papers, many of which are in the hands of the charged firm's client who might, for reasons of self-protection, refuse to produce them. The testimony of many witnesses is usually necessary.... There is no reason to believe that because a 'trial' would be conducted by a self-regulatory organization, it would be significantly simpler or more brief than a civil trial."

POB Report, supra note 245, at 22-23.

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"[W]hile the NTSB investigates events whose occurrence is indisputable, the existence of an audit failure is almost never indisputable. Thus, any investigation to determine whether an audit failure actually occurred, which would be required before 'probable cause' could be pursued, would duplicate the process of adjudicating civil claims for monetary damages and the SEC's disciplinary and injunctive proceedings without additional benefit to the public.

"Moreover, the NTSB's conclusions with respect to 'probable cause,' which are at the heart of the NTSB's work and which form the basis for the remedial measures taken as a result of its investigations, generally may not under the federal securities law be introduced in evidence in any proceeding arising from the accident.... There is at present no law which would prevent the conclusions with respect to the 'probable cause' of an alleged audit failure reached by a self-regulatory body from being introduced in evidence in any SEC, administrative, civil or criminal proceeding."

be modified so that it would issue recommendations on unresolved audit practice issues and other guidance based on its inquiries into possible audit failures.[342]

Conclusions About Self-Regulatory Organization. The debate about the need for legislation creating a self-regulatory organization for the accounting profession has a long lineage. The question appears to resurface whenever a conspicuous pattern of apparent audit failures receives widespread public attention. There appears to be broad consensus among many within the leadership of the profession and among many critics of the profession that creation of a credible, independent self-regulatory organization would enhance the financial reporting system and public confidence in the role of independent auditors.

There is much less consensus about what such a self-regulatory organization should entail. While other self-regulatory organizations such as the NASD might serve as a general model, the role of auditors under the securities laws, as well as the duties owed by auditors toward the investing public, are far different from the function of securities brokers and others regulated under existing self-regulatory organizations. It is worth noting, for example, that a company that wants to access the capital markets through a public offering of securities is not required to use an underwriter to distribute the securities, or to list the securities on an exchange, but must obtain a report on its financial statements by an independent auditor. Moreover, the "market" for auditing services is much more oligopolistic than the "market" for broker-dealer services, since only six firms provide audit services to nearly all public companies.

In light of the importance of the audit function to the integrity of the capital markets, and the concentrated structure of the firms that offer audit services, it seems clear that in order to be credible a self-regulatory organization would need to be independent from the profession, and directly subject to SEC oversight. The primary function of such an entity should be to investigate possible instances of unprofessional or unlawful conduct by auditors, particularly if they may have led to audit failures, and to impose

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POB report, supra note 245, at 25.

[342] Id. at 25, 61.

appropriate disciplinary sanctions.[343] It might also be appropriate for the organization to have some authority to set professional standards, similar to the function currently performed on a voluntary basis by the Peer Review Committee of the SECPS. The overarching objective in structuring such an organization should be to ensure that professional standards are stringently followed by the profession and that possible failures to meet those standards are identified and dealt with more swiftly than now occurs.

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[343] The Public Oversight Board has pointed out that one feature of the National Transportation Safety Board which helps it to enlist cooperation and quickly identify the cause of transportation accidents is that its findings are not admissible in other proceedings. In order to expedite the investigative and disciplinary process and to ensure fairness to accounting firms, some type of comparable protection could be considered for the investigative materials and findings of a self-regulatory organization for auditors.

PART FOUR -- THE STATUTE OF LIMITATIONS

Introduction

In a 1991 decision, Lampf v. Gilbertson, the U.S. Supreme Court reduced the period of time in which investors may bring securities fraud suits under Section 10(b) in a number of jurisdictions. The Court held that investors must file a suit within three years after the fraud occurred, or within one year after the discovery of the fraud.[344] Furthermore, the Court applied its decision retroactively, which made a number of investor lawsuits subject to motions to dismiss, including cases against Michael Milken and Drexel Burnham Lambert, Ivan Boesky, Charles Keating and Lincoln Savings & Loan, and others.

In response, on July 23, 1991, Senator Bryan, joined by Senators Riegle, Graham, Kassebaum, Cranston, Wirth and Shelby, introduced S. 1533, which would have extended the statute of limitations to a period of two years from the date of discovery of a violation, but no later than five years after the violation occurred. Two weeks later, at the Committee's markup of the FDIC Improvement Act (FDICIA), the Bryan bill was adopted as an amendment to the bill.

The Bryan amendment and a similar bill introduced in the House engendered vigorous debate over the statute of limitations issue, as well as over broader issues relating to private securities litigation. A coalition of accounting firms, securities firms and others argued that, if the statute of limitations was to be extended, Congress should at the same time consider the issue of "excessive" securities litigation. Amendments designed to curb certain practices in securities litigation were proposed as further amendments to the banking bill, and the debate that ensued threatened to stall banking reform legislation.

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[344] The case arose because Section 10(b) does not specify a statute of limitations. As a general matter, when Congress has not provided a statute of limitation for a federal cause of action, courts usually "borrow" the state statute of limitation most analogous to the case at hand. Lower courts generally had done this in the case of actions under Section 10(b), but, beginning in 1988, several appellate courts changed course and began looking to other, shorter limitations periods under other provisions of the federal securities laws. The Lampf court decided in favor of the shorter limitations periods provided in sections 9(e) and 18(c) of the Exchange Act for certain express rights of action. Those provisions bar suits filed longer than one year after discovery of the violation or within three years after the violation occurred.

Late in the session, the issue was resolved by including in FDICIA only the provisions of the Bryan amendment that overturned the retroactive effect of the Lampf decision and, therefore, preserved outstanding securities litigation. The issue of extending the statute of limitations prospectively, as well as the issue of broader litigation reform, were deferred until this Congress.

A. Arguments in Favor of a Longer Limitations Period

Critics of the current 3/1 limitations period for implied private rights of action contend that both parts of the limitations period are too short, and have the effect of blocking meritorious cases while doing little to prevent frivolous cases from going forward, and in some instances possibly encourage the filing of cases which might not have been brought if plaintiffs had not felt pressure to file because of concerns about the limitations period.

Some observers who are critical of abuses that they perceive in securities litigation nevertheless support extending the statute of limitations as part of a broader solution to current problems with private securities litigation. For example, the Council of Institutional Investors, which represents a very broad spectrum of investors, was critical of the current securities litigation system in its testimony to the Subcommittee, but in other Congressional testimony has also expressed concern with the current limitations period. An officer of the Council stated:

> "I can assure you that Lampf's requirement to sue within one year from discovery of a crime and within three years of the crime's occurrence will effectively cut off the claims of many pension funds.... These funds are not used to suing to protect their members, and to do so they need time: time to discover the crime, time to hire outside counsel, time to decide if action may be taken, time to get board approval to sue, and time to get other investors to cooperate in the litigation. It is only proper that the pension systems require stringent procedures and approvals before undertaking actions of such great magnitude as a lawsuit....
>
> "We do not wish to encourage inappropriate litigation. We are long term investors in America's markets, and litigation against our companies hurts our investments. But I have seen no evidence that [a proposed longer limitations period] would increase unwarranted strike suits: The strike bar is very efficient and they will have no difficulty meeting the time limits imposed by Lampf. The people who will be harmed are the pensioners on a fixed income who rely on their pension

check for survival, as well as teachers, firefighters, police officers and other workers who will grow in their ranks in the decades to come."[345]

John G. Adler, testifying on behalf of the American Business Conference, stated his support for S. 3181, a bill introduced in the last Congress which contained provisions for reforming securities litigation as well as a provision extending the statute of limitations. Adler stated that "[t]hat sort of balance, which limits frivolous suits while widening the courthouse door for more substantive cases, is precisely the goal this subcommittee should seek."[346] Similarly, the SEC, although it perceives a number of problems with private securities litigation, has expressed strong support for lengthening the statute of limitations, as described below.

1. <u>Arguments for Longer Outer Limit</u>.

The argument against the three-year limit was first stated in the Supreme Court opinion which adopted the current standard. In dissenting from the Supreme Court's decision, Justice Kennedy stated:

> "Concealment is inherent in most securities fraud cases. The most extensive and corrupt schemes may not be discovered within the time allowed for bringing an express cause of action under the 1934 Act. Ponzi schemes, for example, can maintain the illusion of a profit-making enterprise for years, and sophisticated investors may not be able to discover the fraud until long after its perpetration.... The practicalities of litigation, indeed the simple facts of business life, are such that the rule adopted today will thwart the legislative purpose of creating an effective remedy for victims of securities fraud. By adopting a 3-year period of repose, the Court makes a §10(b) action all but a dead letter for

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[345] <u>Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs</u>, 102nd Cong., 1st Sess., S. Hrg. 102-410 at 71 (October 2, 1991) (Testimony of George E. Cones, Jr., Executive Director, Houston Firemen's Relief and Retirement Fund, President, Texas Public Employee Retirement Systems, Executive Committee Chair, Council of Institutional Investors).

[346] Adler statement, Hearing Record at 105. In a subsequent written response to a question from Senator Sasser, Mr. Adler clarified that his support for an extended statute of limitations was linked to legislation which would screen out frivolous cases, and that he would not support a lengthened statute of limitations under the current private securities litigation system. <u>See</u> Response to Written Questions of Senator Sasser From John G. Adler, Hearing Record at 191.

injured investors who by no conceivable standard of fairness or practicality can be expected to file suit within three years after the violation occurred."[347]

The SEC testified to the Subcommittee, as it has previously, that the existing limitations period is too short, and that Congress should extend the limitations period to five years after a violation occurs, or two years after discovery of a violation.[348] The agency suggested that three years may not be enough time for a diligent investor to learn about securities fraud, which is inherently complex. The SEC pointed out that many of its own fraud cases are brought more than three years after the violation occurred. In addition, it challenged the suggestion that the current three-year limitations period is preferable to a longer period because it deters frivolous cases.

> "The most common complaint voiced by litigation reform proponents is that securities fraud actions are filed overnight, without any investigation, whenever an issuer announces reduced earnings or there is a precipitous drop in the market price for a security. To the extent that such cases are going to be filed, a three year statute of limitations is no more effective in preventing them than a five year statute. The shorter limitations period does have the effect, however, of foreclosing relief for the victims of deliberately conceived and carefully hidden frauds."[349]

The SEC has expressed similar concern about the current statute of limitations in previous Congressional testimony. For example, the former Chairman of the SEC pointed out that "[h]ad a three-year statute of limitations been in effect for the Commission, approximately one-half of the cases against Drexel Burnham, a large part of the Equity Funding case, and all of the case against E.F. Hutton for check-kiting would have been barred from the

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[347] Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 111 S.Ct. 2773, 2789 (1991)(dissent by J. Kennedy).

[348] McLucas statement, Hearing Record at 116. See also Breeden testimony, supra note 9.

[349] McLucas statement at 116.

courthouse."[350] In previous testimony before this Subcommittee, the SEC has also cautioned that

> "one result of the Lampf decision could be greater reliance on Commission enforcement actions to deter securities law violations because of the curtailment of legitimate private actions. Expanding the role of Commission enforcement actions would create a heavier public cost unnecessarily, and it is not clear that in the aggregate litigation costs for business would be materially reduced."[351]

The recent settlement between the SEC and Prudential Securities provides an illustration of that phenomenon. The terms of that settlement are described at pages 50-51 above. One feature of the settlement was that Prudential agreed to waive any defense under the statute of limitations for investors who otherwise have a valid claim against the $330 million disgorgement fund established by the SEC.[352]

NASAA also testified in support of a longer statute of limitations. NASAA noted that an investment vehicle can easily last longer than three years. "for example, Ponzi schemes can maintain the illusion of a profit-making enterprise for years, as money from new investors is used to pay off existing investors. It may be many years before such a scheme collapses under its own weight." NASAA also pointed to limited partnership interests and zero coupon bonds as examples of securities for which fraud would be extremely difficult to uncover within three years of an investment. NASAA suggested that the three-year limitations period may discourage investors from making long-term investments.[353]

NASAA noted that at the state level the trend has been to lengthen statutes of limitation for securities fraud, and that nine states have statutes

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[350] Securities Investors Legal Rights: Hearing on H.R. 3185 Before the Subcomm. on Telecommunications and Finance of the House Committee on Energy and Commerce, 102nd Cong., 1st Sess. 25 (1992) (testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission).

[351] Breeden testimony, supra note 9, at 14-15.

[352] SEC v. Prudential Securities, Inc., SEC Litig. Rel. No. 13840 at 3 (October 21, 1993).

[353] Griffin statement, Hearing Record at 125.

of limitation that run only from the time of discovery, with no maximum period of repose.[354] While state statutes of limitation have greatly varying length. NASAA supported a statute of limitations for federal anti-fraud actions under Section 10(b) of the Exchange Act of three years from when the facts constituting the violation were uncovered, or an outer limit of five years from the date of the violation.[355]

2. **Arguments Against One-year Discovery Limitation.**

The second prong of the current limitations period, barring cases filed more than one year after discovery of the facts constituting the violation, has also been criticized from many quarters. The SEC, NASAA and other witnesses have testified, at this and other hearings, that barring cases filed more than one year after discovery has severe consequences. For example, the SEC has noted that the WPPSS securities litigation, which yielded a $750 million recovery for investors, might have been barred if the one-year limitation had been in effect.[356] Likewise, NASAA pointed out that even the SEC, "with all of its investigative resources and statutory powers, including compulsory investigative processes, does not complete its investigations, on average, in less than 2.25 years."[357]

Another criticism made against the one-year discovery limitation is that it may motivate plaintiffs to file cases with less pre-filing investigation than might otherwise occur. This concern has even been expressed by lawyers who frequently represent plaintiffs. For example, Melvyn Weiss stated:

> "A company has disseminated information from time to time over time. Other people are analyzing this company's performance. They are issuing analyst reports and the like. Any disclosure of something that was amiss in that company that might be later tied into the reason for

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[354] Id., Hearing Record at 126.

[355] Id, Hearing Record at 126. NASAA also supported "granting courts the explicit discretion to invoke the doctrine of equitable tolling in those cases where the very nature of the investment instrument (such as is the cases with limited partnerships) makes it virtually impossible for an investor to discover fraud within the statute of limitations." Id.

[356] Breeden testimony, supra note 9 at 25.

[357] Id. at 8, citing Brief of the Securities and Exchange Commission as Amicus Curiae at 24, Lampf v. Gilbertson, 90-333 (June 20, 1991).

the drop can be argued after the fact that the statute started to run at the date of inquiry notice, the date of revelation of that partial disclosure.

"Courts who want to get rid of cases can be driven to dismiss actions because of that. It is a big risk at trial. Sometimes you do not know whether or not the statute is going to be a bar until you get to trial. So when you get into a situation where you have a company whose stock is publicly traded over a period of time, you have to start that action as soon as you can in order to avoid the possibility of a dismissal under the statute, or else you would be guilty of malpractice."[358]

A related concern has been expressed that any limitations period which begins running at the time when plaintiff learns of the facts constituting the violation should not include a "reasonable diligence" requirement.[359] The SEC has opposed such a requirement, noting that

"[i]n financial markets, ... signals [of possible fraud] are often ambiguous. For example, while courts have found that a decline in share price is sufficient to alert an investor to possible fraud, share price declines occur for many reasons. While it is fair to require that investors assert their rights promptly once signs of fraud are clear and unmistakable, investors should not be compelled to investigate ambiguous facts or prematurely to file suits to preserve their rights if fraud might have occurred."[360]

The SEC illustrated its point by citing two cases in which courts, applying a "reasonable diligence" standard, appeared to impose an inequitable burden on

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[358] Hearing Record at 328. Mr. Weiss later expanded on this concern: "Given that most publicly-traded companies regularly disseminate information and that analysts promulgate reports virtually continuously there is a high risk that defense lawyers will seize on any unfavorable disclosure or mention as basis to argue that the plaintiff should have known that fraud was committed. Therefore, to avoid this cumbersome, complex and subjective argument and even potential dismissal, prudent plaintiffs' attorneys have significant incentives to pursue possible claims as expeditiously as possible." Letter from Melvyn I. Weiss to Senator Christopher J. Dodd, August 18, 1993, Hearing Record at 884.

[359] Section 13 of the Securities Act requires that actions under Section 11 or 12(2) of that Act be brought "within one year after the discovery of the untrue statement or the omission, or within one year after such discovery should have been made in the exercise of reasonable diligence." No other limitations period set out in the Securities Act or the Exchange Act contains such a "reasonable diligence" requirement.

[360] Breeden testimony, supra note 9, at 23.

investors. In one case, a court of appeals held that investors were on notice of possible fraud concerning an investment from the moment they received the prospectus, because it disclosed that the issuer had been enjoined in a previous SEC enforcement action for unrelated technical violations. In the other case, a court of appeals held that investors were on notice of possible fraud when a broker lied to them that its legal department had approved the legality of certain transactions. The court reasoned that the investors should have sought independent legal counsel when they learned there was a question of legality.[361]

B. Arguments Against a Longer Limitations Period.

A number of critics of private securities litigation think that a longer statute of limitations is unwarranted. For example, Marc E. Lackritz, the president of the Securities Industry Association, stated in his testimony to the Subcommittee that the current limitations period of one year from discovery and not more than three years from the date of the violation is appropriate. Mr. Lackritz suggested that the one year from discovery limitation was necessary to prevent plaintiffs from "playing the market" after discovering a violation by waiting to see whether the stock price increased or decreased. Responding to the argument that the three-year outer limitation was too short to discover many types of fraud, Lackritz noted that the proliferation of "information technology" has vastly improved the ability of the market to disseminate information, and "makes fraud much more difficult to commit and to keep secret for long periods of time."[362]

Mr. Lackritz also took issue with the suggestion of the SEC and others that the discovery-based limitations period should be based on actual discovery of the violation, rather than when the plaintiff should with "reasonable diligence" have discovered the violation. Lackritz pointed out that courts have generally measured the current one-year limitation from when the plaintiff "knew or should have known" of the violation, rather than when the plaintiff actually learned of the fraud. In Lackritz's view, this approach avoids unnecessary litigation over what a plaintiff actually knew. "An actual knowledge test would be difficult to challenge for veracity. In the absence of an admission or physical evidence, a defendant would have great difficulty

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[361] Id. at 23-24. See Anixter v. Home-Stake Production Co., 939 F.2d 1420 (10th Cir. 1991); Goldstandt v. Bear, Stearns & Co., 522 F.2d 1265 (7th Cir. 1975).

[362] Prepared Statement of Marc E. Lackritz, Hearing Record at 419-20.

proving that a plaintiff had actual knowledge of an event, even if the plaintiff was lying."[363] Lackritz also observed that a requirement of reasonable diligence for possible fraud on the part of investors was good public policy:

> "Rule 10b-5 currently requires that an investor act reasonably and charges the investor with only the knowledge of which a reasonable person is aware. In this, as well as many other settings, the law requires individuals to act as reasonable persons with respect to protecting their interests and conducting themselves. It is consistent with this widely held policy to require investors to exercise reasonable care with respect to their own investments and to be aware only of that information of which a reasonable person could have knowledge. Abandoning a reasonable person standard for Rule 10b-5 private actions and adopting an actual knowledge standard would be anomalous and inconsistent with this ubiquitous and appropriate legal standard."[364]

The AICPA and major accounting firms have also expressed concern with proposals to lengthen the current statute of limitation. Testimony in the last session of Congress by a lawyer representing these groups pointed out several additional considerations in weighing whether to extend the limitations period. For example, Congress has given the SEC, which is not subject to a limitations period, new powers with which to pursue securities law violators, and has supported the SEC's efforts to make ill-gotten proceeds from violations

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[363] Id., Hearing Record at 420. Mr. Lackritz also took exception to the way the SEC characterized Anixter v. Home-Stake Production Company, 939 F.2d 1420 (10th Cir. 1991), which, as described at page 146 above, it had cited in previous Congressional testimony as an illustration of the harsh effect of a "reasonable diligence" standard. Mr. Lackritz noted that the court was impressed by evidence that the plaintiffs should have known about possible wrongdoing much earlier than they claimed their first knowledge, and he quoted the Court's concern that if it only accepted plaintiffs' version of when they first became aware of the violation

> "we would have to ignore the fact that the SEC filed a complaint in February 1971 alleging violations of the registration and antifraud provisions of the securities laws, after which each plaintiff received notice of the court order and rescission remedy. Surely the order, the Rescission offer, The Wall Street Journal article of February 11, 1971 represent 'great glowering clouds,' ... sufficient to put plaintiffs on notice that something was amiss."

Lackritz statement, Hearing Record at 420, note 34 (quoting 939 F.2d at 1438).

[364] Id., Hearing Record at 421.

available to investors. Thus, even if private plaintiffs are unable to bring a case within the current limitations period, the SEC may be able to assist them in obtaining relief. A witness testifying in support of the AICPA also pointed out that extending the statute of limitations would require prudent businesses to retain records concerning transactions for significantly longer periods of time, a burden which in the "detail oriented, paper ridden workplace" of businesses associated with the securities markets could result in substantial storage costs.[365]

C. **Conclusions About Limitations Period.**

Some of those who argue that the current limitations period is appropriate suggest that a longer limitations period could encourage frivolous litigation. On the other hand, some critics of frivolous litigation, such as the Council of Institutional Investors, view the statute of limitations issue as unrelated to the issue of frivolous litigation, and suggest that the current limitations periods are too short. As the SEC pointed out in previous testimony on this issue, "a statute of limitations is not the best means for attacking the problem of baseless or spurious claims. A statute of limitations bars the good cases as well as the bad. Therefore, by use of an unrealistically short statute of limitations, the victims of deliberately conceived and carefully concealed frauds would be disadvantaged along with -- and perhaps to a greater extent than -- those who seek to bring strike suits."[366]

The testimony heard by the Subcommittee does suggest that whether or not to lengthen the statute of limitations has little bearing on the issue of frivolous securities litigation. To the contrary, executives from companies that have defended securities cases which they felt were meritless suggested that one hallmark of many frivolous cases is that they are filed extremely quickly after an adverse announcement, with little time or effort expended in any pre-filing investigation. Moreover, while some witnesses suggested that there is currently an increase in the number of frivolous cases being filed compared to the volume of such litigation a few years ago, that increase, if it actually is occurring, is coming after the Supreme Court shortened the limitations period from the periods that were commonly applied before the Lampf decision.

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[365] Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs 102nd Cong., 1st Sess., (October 2, 1991) (Testimony of Harvey L. Pitt).

[366] Breeden testimony, supra note 9, at 17.

While lengthening the statute of limitations would appear to have little effect on frivolous suits, there is considerable evidence that the current statute of limitations could bar many legitimate cases. ***There does not appear to be any significant dispute about the concerns expressed by the SEC, the Council of Institutional Investors, NASAA and others that a three-year outer limit is simply too little time in which to discover a carefully-constructed fraud.***

There is slightly more dispute about the adequacy of barring cases filed more than one year after discovery of the violation. Some observers defended the current one-year limit by noting that it encourages investors to act promptly when learning of possible fraud. Other observers thought that the one-year limit may penalize those who wish to investigate possible claims with care, and reward those who file lawsuits with little prior effort to examine the facts. This suggests that the one-year limit may actually tend to encourage frivolous litigation.

A more difficult question regarding a discovery-based limitations period is whether it should be measured from the point in time when plaintiff actually learned of a possible fraud, or the point when the plaintiff with "reasonable diligence" should have learned of the fraud. Supporters of a "reasonable diligence" standard argue that if a plaintiff need only make an uncorroborated assertion of when he or she had actual knowledge, a defendant would find it virtually impossible to rebut that assertion. The SEC responded to this argument by suggesting that "[c]ourts may impute the requisite state of knowledge to reckless would-be plaintiffs who choose to hide behind a veil of ignorance. In those cases where an investor realizes from the evidence available to him that fraud has occurred, or is reckless in failing to draw such a conclusion, the investor will indeed be held to have 'discovered' the fraud."[367]

This may suggest that courts could impute knowledge in cases in which investors disingenuously deny knowledge notwithstanding evidence suggesting that a fraud has occurred. Under this approach, there may be less to the "reasonable diligence" versus "actual knowledge" debate than meets the eye. As a practical matter, it may be difficult to distinguish between a standard requiring that a plaintiff acted with reasonable diligence in learning of a fraud and a standard that imputes knowledge for plaintiffs who "hide behind a veil of ignorance" or who "recklessly fail to draw... a conclusion" that fraud has

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[367] Id. at 24.

occurred. Under either approach, courts are likely to decide whether or not to bar a case according to whether they believe the plaintiff should have known about the violation at an earlier point than the point at which the plaintiff claims to have obtained actual knowledge.

Appendix A

Analysis of Studies on Securities Class Actions

Cooper Alexander The genesis of the current debate over the utility of private securities litigation is a 1991 article by Professor Janet Cooper Alexander of Stanford Law School. In her article, Professor Cooper Alexander reported her analysis of nine initial public securities offerings ("IPOs") that took places in the first six months of 1983 by computer companies.[368] Cooper Alexander deliberately selected a group of cases in which all of the elements -- other than the underlying merits of each case -- were as alike as possible. By eliminating other variables, her study aimed to test the extent to which the merits of each case affected the outcome.

The nine cases studied by Professor Cooper Alexander were filed following stock price declines due to a "shakeout" in the computer industry in late 1983. In each of the nine cases, the company's stock had dropped more than $20 million. In contrast, eight other computer companies that conducted initial public offerings were not sued, even though several suffered percentage declines greater than those that were sued. The distinguishing characteristic between these two groups of companies was that the ones that were sued each lost more than $20 million in equity value, while those that were not sued each lost less than $20 million in equity value.

Cooper Alexander found that each of the cases settled within a fairly narrow range around 25 per cent of the potential damages. She argued that this demonstrated that the factual merits did not affect the outcome, and that securities class actions instead served as a form of insurance against market losses. "Whenever a company's stock price decreases suddenly and sharply enough, shareholders file a lawsuit which eventually results in the return to investors of some fraction of their losses.... [P]urchasers of stock are in effect buying two securities: a share of stock and a 'litigation put' entitling them to recover a portion of any ensuing market losses if the stock price falls a sufficient amount."[369]

If true, Cooper Alexander's hypothesis suggests that private securities litigation is a system

[368] Cooper Alexander, supra note 77.

[369] Id. at 570.

"in which a great deal of lawyer effort is expended on both sides without any particular relationship to productivity, and weak cases recover more than they should while strong cases recover less than they should.

"The total recoveries under such a system might be no less than under a merits-based system. Plaintiffs who were the victims of actual securities violations, however, are likely worse off.... A non-merits-based system for resolving litigation effectively transfers wealth from plaintiffs with strong cases to those with weak cases."[370]

Cooper Alexander's study is limited to a relatively small group of cases in the computer industry. While it does strongly suggest that one group of cases involving a particular industry at a particular point in time may have settled on a basis that was unrelated to whether any wrongdoing occurred, it may be difficult to infer a great deal about securities litigation from such a small sample.[371] The Subcommittee received several broader empirical studies that validated or contradicted Cooper Alexander's work in various respects.

Dunbar-Juneja Recently, a broad empirical study by Frederic C. Dunbar and Vinita M. Juneja of National Economic Research Associates, Inc. covered 334 securities class action cases that were resolved between July 1991 and June 1993. Dunbar and Juneja attempted to examine whether the merits of each case affected the outcome by identifying what they believed were merit-related factors to see if such factors influenced settlement outcomes. Dunbar and Juneja found that

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[370] Id. at 577 (emphasis added).

[371] Cooper Alexander's observations could merely suggest that particular types of securities law claims lead to results unrelated to the merits. For example, most of the cases in her study involved claims under Sections 11 and 12(2) of the Securities Act. Under those provisions, issuers are strictly liable for material misrepresentations or omissions in offering materials, and liability against officers, directors underwriters and accountants are also strictly liable unless they are able to affirmatively prove that they acted with due diligence. It is generally easier for plaintiffs to establish liability under these provisions than under Section 10(b) of the Exchange Act, the general anti-fraud provision. The relatively lenient legal standard available to plaintiffs in the cases studied by Professor Cooper Alexander might at least partially explain the uniform results in these cases.

"[w]ithout overstating our statistical findings, if one had to choose among the most important of three factors in explaining settlements -- stock price volatility, availability of assets and merits of the case -- it would appear that the merits matter the least.

"This is not to say that the merits do not matter at all. Our statistical results, though very good when judged by the standard of how well analysts usually explain disaggregate data, leave almost 60 per cent of the dispersion in settlements unexplained. Some of this unexplained variation may be due to factors reflecting the merits about which we have no data. Also, because investor losses may be correlated with either availability of assets or actual damages, some of the explanation of settlement size may depend upon potential damage exposure which in turn may be reflecting the merits of a case."[372]

In conducting their analysis, Dunbar and Juneja looked at two factors that they believed could be indicative of merit: whether there was a securities offering during the class period; and whether a government enforcement action had been brought against the issuer. Dunbar and Juneja reasoned that the existence of a securities offering during the class period was a merit-related factor, because the offering creates possible liability under Section 11 of the Securities Act, which has elements that are easier to prove than liability under the anti-fraud provisions of the Securities Exchange Act. They also assumed that a government enforcement action was an objective indication that a case was more likely to have merit because "[s]uch activity, especially if it results in an order, an indictment or a plea, may reinforce the claims in the securities complaint."[373]

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[372] Dunbar-Juneja study, supra note 72, at 14-15.

[373] Id. at 11. Dunbar and Juneja identified three categories of government "enforcement actions": those in which an investigation is disclosed; those in which a company was ordered or consented to refrain from particular actions; and those in which a defendant pled guilty or was found guilty in a criminal proceeding or was ordered to pay restitution.

Dunbar's and Juneja's assumption that these factors correlate to the merits could be questioned. For example, it is unclear why the availability of a cause of action under Section 11 of the Securities Act would indicate a greater likelihood that fraud or other wrongdoing occurred. As for government investigations, it may be that a case in which a government investigation occurred but no further enforcement effort ensued indicates that subsequent private litigation might lack merit.

Dunbar and Juneja also found that the evidence was consistent with the hypothesis that available assets and insurance coverage play an important role in determining settlement amounts. They found that settlement amounts do not increase proportionately with either investor losses or plaintiffs' damage estimates. They suggested that "[t]he diminishing marginal effect of investor losses on settlements is consistent with the idea that settlement values are constrained by a firm's assets and insurance coverage, which are of course limited."[374] Dunbar and Juneja also found that the inclusion of co-defendants such as accounting firms, law firms or underwriters added over 50 per cent to the expected settlement value of a securities class action. They suggested that this was additional evidence that insurance and other available assets are a major factor in settlements.

The Dunbar-Juneja study also offered some illuminating evidence on several other aspects of securities class action litigation. They found that 281 of the 334 cases in their study were settled, while 45 resulted in dismissal and 8 were tried or resulted in a default judgment. Out of their data pool of cases, they found 135 cases in which both the settlement amount and amount of attorneys' fees awarded were public. In those cases, they found that attorneys' fee awards were on average 31 per cent of the settlement amount. They also broke out of their data pool 84 cases involving common stock which

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[374] Dunbar- Juneja study, supra note 72, at 1.

the amount of recoverable "investor losses" could be calculated.[375] They found that in those cases investors recovered only 7 per cent of their losses.

Drake-Vetsuypens A broad study of initial public offering ("IPO") litigation was published recently by Professors Philip D. Drake and Michael R. Vetsuypens of Southern Methodist University.[376] Drake and Vetsuypens examined 93 law suits brought against companies that had conducted IPOs

[375] The Dunbar-Juneja study limited this portion of its survey to cases involving common stock because the calculation of "investor losses" was too complex for cases involving other types of securities. The Dunbar-Juneja report attempted to define the term "investor losses" as an approximation of recoverable damages. Courts have used a number of different mathematical models for calculating recoverable damages. As discussed at pages 32-33 above, there is an important distinction between economic losses to investors and damages that are recoverable under the federal securities laws. The Dunbar-Juneja study used the following approach:

> "Investor losses are computed in a manner similar to the approach sometimes used by plaintiffs in computing damages. Briefly stated, loss is measured relative to what a class member would have earned with an investment in and S&P 500 Index. This approach attaches an estimate of investor loss to the purchases made on each day during the class period. For shares bought during the class period and held through the end, the loss per dollar invested equals the return on the defendant's stock from the date of purchase to just after the class period ends minus the return on an investment in the index. For shares bought and sold during the class period, the loss per dollar equals the return on the defendant's stock from the date of purchase to the date of sale minus the return on an investment in the index. The number of shares bought on any given day during the class period and either sold on any given subsequent day during the class period or held to the end of the class period is estimated using the proportional decay model developed by John Torkelsen, an expert witness often used by plaintiffs' attorneys."

See Dunbar-Juneja study, supra note 72, at note 8.

[376] Drake and Vetsuypens, IPO Underpricing and Insurance Against Legal Liability," Financial Management 64 (Spring 1993) (hereafter "Drake-Vetsuypens").

between 1969 and 1990.[377] Drake and Vetsuypens reached several findings that were consistent with some of Cooper Alexander's results.

First, they found that the size of the IPO directly correlated to the risk of being sued, which was "qualitatively consistent with [Cooper Alexander's] argument that larger IPOs are more prone to attract litigation" because "lawyers who are compensated based on a percentage of the settlement can increase their expected fees by urging investors in large offerings to bring suit against such issuers."[378] Second, the Drake-Vetsuypens study found that law suits tended to be prompted by declines in market value months or years after the IPO, which they felt supported Cooper Alexander's contention that shareholder law suits tend to be used by some shareholders as a partial hedge against market declines.[379] The Drake-Vetsuypens study also appears to support Cooper Alexander's thesis that securities class action cases tend to occur more frequently where larger losses have occurred.[380]

Drake and Vetsuypens found that the median value of settlements compared to aftermarket losses was 23.8 per cent, compared to Cooper Alexander's study in which settlements averaged around 25 per cent of potential damages.[381] However, there was a significant difference in the

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[377] Their study explored whether the phenomenon of "IPO underpricing" was related to a desire by issuers and underwriters to avoid legal liabilities for possible material misstatements in the offering prospectus or registration statement." IPO underpricing" refers to the tendency of underwriters to set the offering price for an IPO at a level that is likely to fall below the price at which the securities will trade on the secondary market. Typically, the price of a new security will rise from the initial offering price soon after the security begins trading in a secondary market. Drake and Vetsuypens concluded that avoiding litigation liability was not a likely cause of IPO underpricing. Drake-Vetsuypens, supra note 376, at 72.

[378] Id. at 70, 71.

[379] The Drake-Vetsuypens article does not discuss another possible explanation: that litigation tends to follow market price declines because both the plaintiffs and the market are responding to newly uncovered information suggesting wrongdoing.

[380] Drake-Vetsuypens, supra note 379, at 70.

[381] Both the Drake-Vetsuypens article's use of the term "aftermarket loss" and Alexander's use of the term "potential damages" appear to refer to the difference between the IPO price and the price when the "bad news" is disclosed. Cooper Alexander argued that in the case of IPOs the potentially recoverable damages and market loss are the same for stock purchased in the IPO and held until after the bad news triggering the law

range of settlements in the Drake-Vetsuypens study and the Cooper Alexander study. The cases studied by Cooper Alexander settled within a narrow range of 20 and 27 per cent of potential damages, while the 93 cases studied by Drake and Vetsuypens settled over a much broader range. Drake and Vetsuypens found that the average recovery was 11.1 per cent of aftermarket loss for the lowest quartile of cases, and 44.5 per cent for the highest quartile of cases.[382]

O'Brien Vincent O'Brien conducted a study with Richard W. Hodges of 533 class actions filed between April 1988 and March 1993. In testimony before the Subcommittee O'Brien stated that

> "there is way too much of this type of litigation.... It seems unlikely that American companies are engaging in fraud on such a massive scale (and that plaintiffs are able to pick their targets with such pinpoint accuracy). Rather, something is forcing innocent defendants to settle.... A remedy that can be invoked with essentially the same level of success in virtually every case, regardless of the true merit of a claim, does not single out malefactors and force them to bear an especially heavy burden -- either in economic terms or in terms of the public opprobrium that would accompany an adverse judgment or large settlement under a more discriminating system."[383]

Mr. O'Brien asserted in his testimony that "a disproportionate share of the cases were against young, medium-sized high technology firms." However, O'Brien also noted that "being a mature company didn't protect one from one of these suits as fully two-thirds of the sued companies were more than ten

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suit is disclosed. See Cooper Alexander, supra note 77, at 515. One possible objection to both Alexander's article and the Drake-Vetsuypens article is that the term "potential damages" or "aftermarket loss" is loosely defined or meaningless. William S. Lerach made this objection in a slightly different context in his testimony, by pointing out that damages recoverable under the securities laws are often complex to determine, and usually substantially less than actual investor market losses. See Lerach statement, Hearing Record at 143.

[382] Drake-Vetsuypens, supra note 376, at 69.

[383] Prepared statement of Dr. Vincent E. O'Brien, Hearing Record at 140.

years old. Companies with over $10 billion in revenues were sued as frequently as their $10 million brethren."[384]

Some of the conclusions drawn by Mr. O'Brien in his testimony, such as his assertion that there is "too much" securities litigation, or that securities class action litigation is "forcing innocent defendants to settle" appear to be much broader than the findings of his study. For example, while O'Brien's study found that one out of every eight companies traded on the New York Stock Exchange was sued, and that 342 companies paid $2.5 billion in settlements in the cases that he studied, the study does not offer a clear basis for concluding what portion, if any, of these cases were "too much" or involved innocent defendants who were forced to settle.

O'Brien's study found that companies that were sued almost invariably suffered a decline in stock price, with an average price decline of 50.5 per cent. He also found that 93 per cent of the cases in his sample settled, while 6 per cent were dismissed and one per cent were tried.[385] O'Brien's sample gave no clear indication that a company's size played a role in whether or not it was sued. His study showed that 20 per cent of the companies sued had a market capitalization of over $1 billion, while 17 per cent had a market capitalization of under $50 million. There also did not appear to be any clear link in O'Brien's study between the nature of a company's business and its likelihood of being

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[384] Id., Hearing Record at 138.

[385] Mr. O'Brien's claim that 93 per cent of securities class actions settle has been challenged by one critic who pointed out that O'Brien took his sample from a source which underreports cases which are dismissed.See Beverly C. Moore, Jr., 14 Class Action Rep. 485 (1991); 16 Class Action Rep. 244 (1993). The settlement rate shown in Mr. O'Brien's study is also inconsistent with a report submitted by the "Big Six" accounting firms, which showed that of 396 securities cases resolved by them in 1990-1992, 234, or 59 per cent were settled, while the others were dismissed or tried. See Table I, page 100 above.

Mr. O'Brien's work was also challenged by another witness at the hearing, Edward J. Radetich. Mr. Radetich, who was the claims administrator for a number of the cases cited in Mr. O'Brien's study, noted his firm was the claims administrator in seven of the subset of 20 cases on which O'Brien drew many of his conclusions, and that the actual recoveries to investors in those cases were much higher than O'Brien's figures showed. Radetich also criticized a statement by O'Brien concerning the amount of recovery by institutional investors. Radetich suggested that O'Brien failed to consider that most of the recovery by institutional investors was by mutual funds or pension funds on behalf of thousands of small investors. Letter from Edward J. Radetich to Senator Christopher J. Dodd, August 12, 1993.

sued. While approximately 22 per cent of the companies sued were in the finance, insurance, or real estate industries, O'Brien's study identified seven other categories of businesses each of which accounted for 5 per cent or more of the securities litigation in his sample.[386]

Torkelson, Radetich and Gilardi At the June 17, 1993 hearing, William S. Lerach suggested that recoveries in securities class actions were around 60 per cent of recoverable damages, much higher than the recovery percentages found by other studies. Lerach suggested that this 60 per cent recovery rate suggested that "the system has, in the main, worked well." Lerach's 60 per cent recovery rate challenges the argument made by O'Brien and other critics of securities litigation that extremely low recovery rates show that securities litigation cases are frequently frivolous.

Lerach's suggested recovery rate is based on three studies, one by John B. Torkelson, the President of Princeton Venture Research, Inc. ("PVR"), a firm which specializes in calculating securities damages for securities litigants, and one each by Edward J. Radetich, the President of Heffler & Company, and by Dennis Gilardi, President of Gilardi & Co., both of whom specialize in distributing settlement proceeds to class members.

The Torkelson study analyzed settlements in a group of 20 cases in which PVR had been retained as damage experts and in which its damage estimates and computer files were readily available. Torkelson concluded from an analysis of these cases that legally recoverable damages were, on average, 27.7 per cent of market losses.

Mr. Radetich and Mr. Gilardi both submitted studies to the Subcommittee in which they compared the amounts which were distributed to class members in securities class action settlements to the total amount of market losses suffered by class members. They pointed out that their comparisons did not take into consideration the amount of market losses which would have been legally recoverable. Their combined numbers show that in

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[386] O'Brien study at I-6, I-8. The categories experiencing the most securities litigation were: "finance, insurance and real estate (22.3 per cent); "industrial machinery and equipment, including computers" (13.1 per cent); "chemicals and allied products" (8.1 per cent); "business services" (7.9 per cent); "retail trade" (6.1 per cent); "transportation and public utilities" (5.7 per cent); "electronic and other equipment (5.0 per cent); and "instruments and related products" (5.0 per cent).

173 distributions, the total market losses were $10,598,144,785. Of this amount a total of $1,754,921,204 was paid to claimants.

Based on the Torkelson, Radetich and Gilardi figures, Mr. Lerach calculated that in the 173 cases reported by Radetich and Gilardi, 59.78 per cent of the amount of legally recoverable damages were actually recovered by plaintiffs. Mr. Lerach arrived at this conclusion by taking Torkelson's finding that 27.7 per cent of market losses were legally recoverable damages, and multiplying that percentage by the $10.598 billion in market losses in the 173 cases considered by Radetich and Gilardi, to arrive at a figure of $2,935,686,104 in legally recoverable damages that were potentially available in those cases. The $1.755 billion actually recovered and distributed to claimants comprised nearly 60 per cent of recoverable damages under Lerach's analysis.

A representative of the six major accounting firms disputed Lerach's conclusion that his analysis demonstrated that roughly 60 per cent of legally recoverable damages are actually recovered. An attorney representing the six largest accounting firms pointed out that in the 20 cases relied upon by PVR, the actual settlement amounts that were approved by courts represented 23 per cent of the damages that PVR calculated were recoverable. In addition, in 13 of those cases for which attorneys' fee awards were publicly available, the average recovery for plaintiffs after subtracting fee awards was 13 per cent of legally recoverable damages.[387] According to this study, in the 13 cases for which fee awards were available, the average amount of the settlement expended on fees and expenses was 39 per cent.

This study in turn has been questioned by James M. Newman, the publisher of Securities Class Action Alert, a publication that publishes data on securities class action cases. Newman asserted that in at least one instance, a case which was described by the Gitenstein study as yielding a 12 per cent return for investors actually resulted in a 100 per cent return. Newman apparently bases this conclusion on the fact that the settlement fund was not exhausted.[388]

[387] Letter to Martha L. Cochran from Mark H. Gitenstein, August 6, 1993, Hearing Record at 709.

[388] Statement of James M. Newman, August 16, 1993, Hearing Record at 777.

Marino In a recent study Steven P. Marino and Renee D. Marino analyzed 229 securities class action settlements between April 1989 and February 1994 involving accountants, attorneys, or underwriters.[389] The study attempted to distinguish securities class actions involving allegations of "flagrant fraud" (e.g., embezzlement, insider trading or falsifying sales figures) from cases involving "nonflagrant fraud (e.g., misstated balance sheets or incorrect earnings projections). The study found that the cases classified by the authors as "flagrant fraud" settled on average for more than double the settlements in cases involving "non-flagrant fraud."[390] "This finding is contrary to Janet Cooper Alexander's conclusions that case merits do not matter in determining settlement amounts....[The] findings...show that merits do seem to matter and that the most egregious acts result in larger legal penalties. This suggests that the judicial system is at least partially working in the securities class action liability arena."[391]

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[389] Marino study, supra note 146.

[390] Flagrant fraud is defined in the study as intentional breaking of the law and includes such categories as insider trading, market manipulation, embezzlement, ponzi schemes fabricated sales, and undisclosed felony records of key individuals. Non-flagrant fraud, on the other hand refers to judgment calls by the management such as the appropriate capitalization of an investment, the correct time to recognize a loss and revaluing assets. Marino study, supra note 146, at 7.

[391] Id. at 25.

Appendix B

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